



# **NAVAL POSTGRADUATE SCHOOL**

**MONTEREY, CALIFORNIA**

## **THESIS**

**COERCIVE LEVERS IN CHINESE ECONOMIC  
STATECRAFT: ATTRIBUTED ACROSS EARTH,  
RARELY APPARENT**

by

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June 2012

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ATTRIBUTED ACROSS EARTH, RARELY APPARENT**

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## **ABSTRACT**

This study considers the role of coercive lever exercise in Chinese economic statecraft. Whereas the economic statecraft literature presumes larger economic powers dominate smaller economic powers, this study considers cases in which asymmetric interdependence in specific sectors allows relatively less developed states to access coercive levers as viable policy options. It found that coercive lever exercise remains rare relative to inducements in Chinese economic statecraft consistent with evolving Chinese grand strategy and political economy trends. As demonstrated in the case studies, exercise patterns were reactionary and depended on existing conditions of asymmetric interdependence with the target state. Beijing can and will exercise coercive levers in the context of a bilateral trade dispute or during select high-stakes international crises, but only to an extent that exercise supports achievement of limited political objectives such as signaling resolve, amplifying official protest or altering short-term behavior in the target state. Though reluctant to exercise coercive levers, China's capabilities are evolving and it is becoming a more confident practitioner that selects among an increasingly sophisticated range of policy options in economic statecraft. As China continues to deepen integration with the global economy, coercive levers derived from asymmetric interdependence will likely proliferate.

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## **LIST OF ACRONYMS AND ABBREVIATIONS**

APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
ACFTA	Association of Southeast Asian Nations - China Free Trade Agreement
CCP	Chinese Communist Party
CIC	China Investment Company
EAS	East Asia Summit
ECS	East China Sea
EEZ	exclusive economic zone
EU	European Union
FALSG	Foreign Affairs Leading Small Group
FDI	foreign direct investment
FLEC	Fisheries Law Enforcement Command
FTA	free trade agreement
GATT	General Agreement on Trade and Tarrifs
GDP	Gross Domestic Product
IETCC	International technological cooperation corporations
IPE	International Political Economy
JMSDF	Japan Maritime Self Defense Force
LSG	Leading Small Group
METI	Ministry of Economy Trade and Industry
MLR	Ministry of Land and Resources
MFA	Ministry of Foreign Affairs
MIIT	Ministry of Industry and Information Technology

NDS	National Defense Strategy
NDRC	National Development and Reform Commission
NMS	National Military Strategy
NOC	national oil company
NPL	non-performing loans
NSS	National Security Strategy
PBSC	Politburo Standing Committee
PLA	People's Liberation Army
PPP	Purchasing Power Parity
PRC	People's Republic of China
R&D	research and development
REE	rare earth element
REO	rare earth oxide
SASAC	State-owned Assets Supervision and Administration Commission of the State Council
SCS	South China Sea
SmCo	Samarium Cobalt
SOE	state owned enterprise
TALSG	Taiwan Affairs Leading Small Group
TPP	Trans-Pacific Partnership
UNGA	United Nations General Assembly
UNSC	United Nations Security Council
UNCLOS	United Nations Convention on the Law of the Sea
WTO	World Trade Organization

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# **I. THE RISE OF CHINESE ECONOMIC STATECRAFT**

## **A. INTRODUCTION**

### **1. Japan Bashing with Chinese Characteristics**

On September 23, 2010, China suspended rare earth exports to Japan in response to a maritime crisis near the disputed Senkakus Islands, located in the East China Sea. These sanctions followed weeks of diplomatic efforts to release a Chinese fishing boat Captain detained by Japanese authorities after his trawler collided with two Japanese Coast Guard vessels earlier in September. There was no press conference announcing these sanctions on 17 elements found on the periodic table and in thousands of advanced applications in the global economy; industry sources notified the media that outbound shipments to Japan remained tied to the pier. In fact, before these reports, most informed readers probably associated rare earths with geologists rather than geopolitics. Yet to observers like economist Paul Krugman, the episode revealed a “rogue economic superpower, unwilling to play by the rules.”<sup>1</sup> The implications played into the ongoing U.S. political debate over China’s relative economic gains since the 2008 global financial crisis and fears Beijing might use its economic power to undermine the international system. If China sanctioned Japan over a relatively minor maritime crisis, then it might just as easily ban other exports, manipulate its currency or unload vast holdings of U.S. debt to get its way in international politics.

Rare earths became intertwined with competing interpretations of China’s economic rise, its deepening integration with the global economy, and the benefits and risks of interdependence. Economic statecraft is an increasingly visible feature of Chinese behavior in the international system. Broadly defined, economic statecraft is politics by economic means. Known as levers, means can induce (e.g., foreign aid) or coerce (e.g., sanctions). Exercise of both types of levers is neither new nor unusual in international relations. Yet the process driving the decision to exercise coercive levers in Chinese economic statecraft is not well understood. For example, why did Beijing target

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<sup>1</sup> Paul Krugman, “Rare and Foolish,” *The New York Times*, October 18, 2010, A35.

Tokyo during this particular crisis? Why did it select rare earths as an economic lever in response to a security crisis? What did it hope to achieve politically? This study analyzes the 2010 Senkakus crisis and compares how China exercised sanctions in that case with other examples of coercive levers in Chinese economic statecraft over the past decade. It poses a basic question: What is the role of coercive levers in Chinese economic statecraft?

## **2. Infinite Interpretations of China's Rise, Few Coercive Levers**

How China intends to use its economic power after more than thirty years of unprecedented growth is among the most pressing topics in contemporary international relations. This concern is not unique to the economic sphere. Analysis of Chinese foreign policy behavior in political and military issue areas confronts similar open questions, from People's Liberation Army (PLA) modernization to Chinese territorial claims in the South China Sea. The vast extent of Chinese integration with the global economy is undeniable, however. China is the premier manufacturing, trading and foreign direct investment (FDI) hub in East Asia, the world's largest producer and its second largest economy, and the leading trade partner with the European Union, the United States and Japan among many others.<sup>2</sup> These developments have not only raised China's global economic clout, but also broadened Beijing's opportunities to increase political influence abroad through economic statecraft.

As a topic that integrates political economy and international relations issues, economic statecraft is an increasingly visible feature of China's evolving role in the international system. Given that economic statecraft is the exercise of economic means to achieve political goals, beyond the precondition of sufficient economic power, developing relationships through economic exchanges is the first step toward wielding it successfully. Examples abound of Chinese efforts to develop commodities markets from Middle Eastern oil and African minerals to Latin American steel and South East Asian timber, often displacing Japan or the United States as the primary trading partner in these

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<sup>2</sup> For a discussion of Chinese integration in East Asia, see for example: Andrew MacIntyre, T.J. Pempel and John Ravenhill eds., *Crisis as Catalyst: Asia's Dynamic Political Economy* (Ithaca: Cornell University Press, 2008).



regions.<sup>3</sup> Within East Asia, China's expansive economic ties with South Korea, its "economics first, politics later" approach across the Taiwan Strait and its charm offensive in Southeast Asia evoke shifts in the so-called regional balance of influence.<sup>4</sup> Many of these activities support China's foreign policy efforts to assuage fears its post-Cold War rise will be less than peaceful, to accommodate neighbors when feasible and to manage its global reputation as a "responsible major power" that promotes "win-win" cooperation abroad.<sup>5</sup>

Despite an apparent ubiquity of Chinese economic activity across the globe, examples of coercive levers in economic statecraft are both rare and understudied. By comparison, the United States has no less than 11 different types of active sanctions against China alone, many dating back to the 1989 Tiananmen crisis.<sup>6</sup> Either China does not apply coercive levers often, or at the very least, these actions are underreported. Or, as scholars Abdelal and Kirshner note, this "dearth of examples of such coercion" may reflect an evolving foreign policy preference for benign influence over more explicit forms of coercion.<sup>7</sup> In fact there are examples of Chinese coercive levers affecting select trade markets for short durations, including the China-South Korea "garlic wars," the China-Japan "tatami mat wars" and sanctions against business interests associated with former Taiwanese President Chen Shui-Bian in the early 2000s.<sup>8</sup> In another example, China briefly suspended economic exchanges with Singapore in response to then Deputy

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<sup>3</sup> U.S. Library of Congress, Congressional Research Service, *China's Foreign Aid Activities in Africa, America, and Southeast Asia*, by Thomas Lum, et al., CRS Report R40361 (Washington, DC: Office of Congressional Information and Publishing, February 25, 2009).

<sup>4</sup> William W. Keller and Thomas G. Rawski, eds., *China's Rise: And the Balance of Influence in Asia* (Pittsburgh: University of Pittsburgh Press, 2007); Alan D. Romberg, "Taiwan Elections Head to the Finish: Concerns, Cautions, and Challenges" *China Leadership Monitor* 36 (2012), 19.

<sup>5</sup> Susan Shirk, "The Responsible Power," in *China: Fragile Superpower* (NY: Oxford University Press), 105–139.

<sup>6</sup> U.S. Library of Congress, Congressional Research Service, *China Economic Sanctions*, by Dianne E. Rennack, CRS Report RL31910 (Washington, DC: Office of Congressional Information and Publishing, February 1, 2006).

<sup>7</sup> Rawi Abdelal and Jonathan Kirshner, "Strategy, Economic Sanctions, and the Definition of National Interests," *Security Studies* 9:1–2 (1999): 119–156.

<sup>8</sup> Robert S. Ross, "Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia" *Security Studies* 15:3 (2006): 355–395; Adam Segal, "Chinese Economic Statecraft and the Political Economy of Asian Security" in *China's Rise and the Balance of Influence in Asia*, ed. William W. Keller and Thomas G. Rawski (Pittsburgh: University of Pittsburgh Press, 2007): 146–161.

Prime Minister Lee Hsien Loong's unofficial visit to Taiwan in 2004.<sup>9</sup> Major long-term examples involve China's ongoing participation in multi-lateral nuclear non-proliferation sanctions against Iran and North Korea under the auspices of United Nations Security Council resolutions 1929 and 1874.<sup>10</sup> Despite these examples, China tends to prefer non-coercive levers that induce rather than coerce.

In broad terms, this study analyzes means and ends driving Chinese economic statecraft. Since the 1990s, a growing literature assessed state responses to China's economic rise, China's deepening integration with the global economy, and Chinese economic statecraft.<sup>11</sup> Given limited data and scholarly analysis of coercive levers, Chinese preferences for exercising those levers are unclear.<sup>12</sup> This study seeks to parse out the underlying mechanism driving coercive levers in Chinese economic statecraft. How does Beijing select a particular lever to punish a target state or another foreign policy actor? What conditions, events or issues could trigger the decision to exercise the lever? How does Beijing exercise the lever, for how long and what does it want to achieve? In an effort to explain this process in contemporary Chinese economic statecraft, this thesis focuses on examples of coercive levers over the past decade. In particular, it considers cases since China's accession to the World Trade Organization in 2001, a period in which China deepened integration with the global economy and accelerated economic growth. At the same time, asymmetric interdependence evolved in

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<sup>9</sup> Amitav Acharya, *Singapore's Foreign Policy: The Search for Regional Order* (Singapore: World Scientific, 2008): 100–105.

<sup>10</sup> See U.S. State Department fact sheet on UNSC Resolutions 1718 and 1874 accessed at: <http://www.state.gov/r/pa/prs/ps/2009/06a/124709.htm>

<sup>11</sup> Miles Kahler and Scott L. Kastner, "Strategic Uses of Economic Interdependence: Engagement Policies on the Korean Peninsula and Across the Taiwan Strait," *Journal of Peace Research* 43:5 (2006): 524–541; Scott L. Kastner and Paul A. Papayouanou, "Assessing the Policy of Engagement with China," *Policy Papers* Institute on Global Conflict and Cooperation, University of California Berkeley, July 1998; Evan S. Medeiros et al., *Pacific Currents: The Responses of U.S. Allies and Security Partners in East Asia to China's Rise* (Santa Monica: RAND Corporation, 2008); Ross, "Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia"; Adam Segal, "Chinese Economic Statecraft and the Political Economy of Asian Security." In *China's Rise and the Balance of Influence in Asia*, ed. William W. Keller and Thomas G. Rawski, (Pittsburgh: University of Pittsburgh Press, 2007): 146–164; John Ravenhill, "Is China an Economic Threat to Southeast Asia," *Asian Survey* 46:5 (September/ October 2006): 653–674.

<sup>12</sup> According to neo-liberal theorists, state preferences, or interests, are shaped by domestic politics and the external environment. See Andrew Moravcsik, "Taking Preferences Seriously: A Liberal Theory of International Politics." *International Organization* 51:4 (1997): 513–553.

select economic niches, expanding Beijing's capability to exercise levers in economic statecraft.

### 3. Integration, Interdependence, and Power Transition Theory

Chinese economic statecraft relates directly to competing interpretations of China's rise and whether China will become a revisionist or status quo power.<sup>13</sup> For those who perceive a revisionist China, its deepening integration with the global economy grips popular, academic and policy imaginations that increasingly interpret any aspect of Chinese foreign policy behavior as a threat. Economic statecraft increases China's relative power in support of revisionist aims, including aspirations to regional hegemony in East Asia while pushing out the United States.<sup>14</sup> Coercion then confirms the obvious by crossing the functional boundary between economics and security on behalf of revisionist politics. Others contend the global proliferation of Chinese economic exchanges and economic statecraft in developing states undermines liberal democracy by exporting a China development model that is neither liberal, nor democratic.<sup>15</sup>

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<sup>13</sup> Examples of this vast literature are: Jack S. Levy, "Power Transition Theory and the Rise of China" in *China's Ascent: Power, Security and the Future of International Politics*, ed. Robert S. Ross and Zhu Feng (Ithaca: Cornell University Press, 2008): 11–33; Avery Goldstein, "Power Transitions, Institutions, and China's Rise in East Asia: Theory, Expectations and Evidence," in *The United States and Northeast Asia: Debates, Issues and New Order*, ed. G. John Ikenberry and Chung-In Moon Lanham (MD: Rowman and Littlefield, 2008), 39–78.; Thomas J. Christensen, "Fostering Stability or Creating a Monster? The Rise of China and U.S. Policy toward East Asia," *International Security*, 31:1 (2006): 81–126.; Alastair Iain Johnston, "Is China a Status Quo Power?," *International Security*, 27:4 (2003): 5–56.; Alastair Iain Johnston and Robert S. Ross eds., *Engaging China: The Management of an Emerging Power* (London: Routledge, 1999).

<sup>14</sup> Stephen M. Mosher, *Hegemon: China's Plan to Dominate Asia and the World* (San Francisco: Encounter Books, 2000); John J. Mearsheimer, "Great Power Politics in the 21st Century," *The Tragedy of Great Power Politics* (New York: W.W. Norton, 2001): 360–402; C. Fred Bergsten, "China and Economic Integration in East Asia: Implications for the United States," Peterson Institute in International Economics, *Policy Briefs* PB07-3 (2007): 1-10; Arvind Subramanian, "The Inevitable Superpower: Why China's Dominance is a Sure Thing," *Foreign Affairs* 90:5 (2011).

<sup>15</sup> Joshua Kurlantzick, *Charm Offensive: How China's soft Power is Transforming the World* (New Haven: Yale University Press, 2007); Eric Farnsworth, "The New Mercantilism: China's Emerging Role in the America's," *Current History* (2011); Nazneen Barma and Ely Ratner, "China's Illiberal Challenge," *Democracy: A Journal of Ideas* 2 (Fall 2006): 56–68. For a counterargument, see Scott Kennedy, "The Myth of the Beijing Consensus," *Journal Of Contemporary China* 19:65 (June 2010): 461–77.

According to proponents of a status quo China, this deepening economic integration and economic statecraft reflect the inevitability of China's rise in East Asia. Instead of conflict, this process presents engagement opportunities to socialize China to status quo norms, promote regional economic growth and enhance global stability. In contrast with revisionist advocacy for less Chinese economic statecraft, the status quo approach argues for more. For example, the United States lauded China's oil embargo and financial asset freeze against North Korea during the 2003 and 2006 nuclear crises, and it continues to rely on Beijing as a key intermediary with the hermit kingdom.<sup>16</sup> Driven by massive energy demand, Chinese investment in hydrocarbon sources has enhanced competition and diversified global energy supplies.<sup>17</sup> And China's Southeast Asian charm offensive has not necessarily undermined U.S. influence in that region, and instead, helped Southeast Asia in ways aligned with U.S. interests.<sup>18</sup> Certainly China's economic rise challenges the status quo international system in important ways, potentially altering rules and norms to suit Chinese interests.<sup>19</sup> Though many Sinologists contend Beijing is more concerned with sustaining economic development through deepening integration in the global economy, than with revising a system it pursued for more than forty years.<sup>20</sup>

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<sup>16</sup> David M. Lampton, *The Three Faces of Chinese Power: Might, Money, And Minds* (Berkeley: University of California Press, 2008), 172–3.

<sup>17</sup> Theodore H. Moran, *China's Energy Strategy to Secure Natural Resources: Risks, Dangers, and Opportunities* (Washington D.C.: Peterson Institute for International Economics, 2010), 41.

<sup>18</sup> Michael A. Glosny, "Heading Toward a Win-Win Future? Recent Developments in China's Policy Toward Southeast Asia," *Asian Security* 2:1 (2006): 24–57.

<sup>19</sup> Daniel W. Drezner, "Bad Debts Assessing China's Financial Influence in Great Power Politics," *International Security* 34:2 (2009): 7–45; Jonathan Kirshner, "The Consequences of China's Economic Rise for Sino-U.S. Relations: Rivalry, Political Conflict, and (Not) War," in *China's Ascent: Power, Security and the Future of the International Politics* Robert S. Ross and Zhu Feng, eds. (Ithaca: Cornell University Press, 2008): 238–259.

<sup>20</sup> Forty years is based on U.S.-China rapprochement in 1971–2 and PRC recognition in the United Nations on November 25, 1971, replacing the Republic of China (ROC). Political economy treatments of China's rise include: C. Fred Bergsten et al, eds., *China's Rise: Challenges and Opportunities* (Washington D.C.: Peterson Institute for International Economics, 2009); William W. Keller and Thomas G. Rawski, ed. *China's Rise: and the Balance of Influence in Asia* (Pittsburgh: University of Pittsburgh Press, 2007); Edward S. Steinfeld, *Playing Our Game: Why China's Rise Doesn't Threaten the West* (New York: Oxford University Press, 2010); C. Fred Bergsten, Bates Gill, Nicholas R. Lardy, Derek Mitchell, *China, The Balance Sheet: What the World Needs to Know about the Emerging Superpower* (New York, Public Affairs, 2007).

Economic statecraft depends on interdependent economic exchanges to advance political interests. Interdependence is not risk free; its quality matters.<sup>21</sup> Advocacy for deepening economic integration with China regardless of security consequences may reflect the elusive “China dream” of 1.32 billion consumers – a variant of Norman Angell’s cautionary tale in *The Great Illusion*.<sup>22</sup> From a Chinese perspective, export-led growth based increasingly on U.S., European and Japanese demand raises a complementary dilemma: “the more developed and prosperous the country becomes, the more insecure and threatened they [the CCP] feel.”<sup>23</sup> The relevant question for analysts is whether economic interdependence between states skews to one side over the other, creating a disproportionate capacity for political influence. This asymmetric interdependence can exist broadly at the aggregate economic level or narrowly in specific economic issue areas.<sup>24</sup>

Chinese economic statecraft involves economic issues that arise with considerable frequency between states, such as trade disputes, energy resource competition and foreign aid distribution.<sup>25</sup> These issues typically do not provoke war, but can become persistent sources of intense “political conflict and rivalry” between states that, if managed poorly, alter the course of bilateral relationships.<sup>26</sup> These issues amount to the facts of life in foreign affairs. In this context, economic statecraft is a fairly routine tool of national power; coercive lever exercise does not necessarily convey a value judgment on whether a state has revisionist or status quo intentions.<sup>27</sup>

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<sup>21</sup> See Kenneth Waltz’s discussion of interdependence as a mutual vulnerability in chapter 7 of *Theory of International Politics* (New York, McGraw Hill, 1979): 128–160; Robert O. Keohane, and Joseph S. Nye, *Power and Interdependence* (New York, NY: Longman Publishers, 1977). Susan Shirk *China: Fragile Superpower* (Oxford, UK: Oxford University Press, 2008): 24–34.

<sup>22</sup> The term comes from Joe Studwell, *The China Dream: The Quest for the Last Great Untapped Market on Earth* (New York: Grove Press, 2003): 3-25.

<sup>23</sup> Susan Shirk, *China: Fragile Superpower*, 5.

<sup>24</sup> Keohane and Nye, *Power and Interdependence*, 242.

<sup>25</sup> Robert Keohane and Joseph Nye were the first to point out that military force is relatively rare in international relations and that military power does not easily convert to other issue areas.

<sup>26</sup> Kirshner, “The Consequences of China’s Economic Rise for Sino-U.S. Relations: Rivalry, Political Conflict, and (Not) War,” 238–259.

<sup>27</sup> Chris Buckley, “UPDATE 1-China denounces U.S. sanctions on company dealing with Iran,” *Reuters*, January 14, 2012.

Most of the attention given to expanding Chinese economic exchanges and economic statecraft involves weaker, developing nations in which Chinese wealth has obvious advantages. This view is consistent with the economic statecraft literature pioneered by Albert Hirschman on the advantages of larger states over smaller states in trade relations.<sup>28</sup> This study argues asymmetric interdependence in specific sectors allows China to pursue economic statecraft against more powerful states with more sophisticated market economies. These conditions present Beijing with levers it is uniquely positioned to exercise. But it is less clear when these conditions will prevail, and under what circumstances coercive levers will arise as viable policy options.

#### **4. Why Study Coercive Levers in Chinese Economic Statecraft?**

This study focuses on Chinese economic statecraft for three reasons. First, sustained economic growth is the principal feature of China's rise, which as a consequence, represents a source of both international prestige and domestic political legitimacy.<sup>29</sup> Reflecting a strong growth-oriented consensus, Chinese Communist Party (CCP) leadership prioritized economic development consistently since the inauguration of Deng Xiaoping's reforms in 1979. In the 1990s, Chinese leadership embraced globalization as a necessary condition to continued growth and launched another phase of economic reforms designed to deepen integration with the global economy. Since then, the Chinese economy sustained unprecedented growth (~9.5% annual GDP) and achieved two key milestones: accession to the World Trade Organization in 2001 and overtaking Japan as the world's second largest economy in 2010.

Second, due to high levels of interdependence between China and the global economy, economic statecraft plays an increasingly important role in Chinese foreign policy by promoting Chinese growth at home and influence abroad. Beijing typically refers to these efforts as "economic diplomacy" to support its "peaceful development," but this context is consistent with economic statecraft as defined in the literature. A

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<sup>28</sup> Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (1945; Berkeley: University of California Press, 1980).

<sup>29</sup> For a discussion of China's efforts to develop comprehensive national power, see Lampton, *The Three Faces of Chinese Power: Might, Money, and Minds*.

prevailing consensus among scholars follows that Chinese leaders are convinced preserving a benign foreign policy environment is crucial to sustaining economic growth, and therefore, the CCP's political legitimacy.<sup>30</sup> In sum, economic development is Beijing's primary domestic and foreign policy priority. As a component of Chinese grand strategy, economic statecraft supports the preservation of a benign foreign policy environment to sustain domestic growth. It also promotes China as a responsible major power abroad.

Third, scholars focus too much on the security aspects of China's rise and not enough on economic issues. This study's emphasis on economic statecraft does not discount the importance of security issues, rather it relates directly to "security externalities" that develop as a consequence of economic exchanges.<sup>31</sup> Chinese economic statecraft can and does shape security outcomes, though results are mixed.<sup>32</sup> Development of asymmetric interdependence in the rare earth industrial sector and then exercise of the rare earth lever in a security crisis is a key example. Instead of the shifting naval balance in the Western Pacific, or other apparently efficacious symbols of China's rising power, this study looks at punitive mechanisms in economic statecraft that, falling short of armed conflict, crosscut economic and security issues in meaningful ways. Analysis across these issue areas is therefore crucial to enriching understanding of Chinese economic statecraft and providing the academic and policy communities with accurate content. It follows that coercive lever analysis isolates a variable with comprehensive implications for Chinese foreign policy behavior.

## **5. Thesis Overview**

This study is organized into two parts. The first part covers domestic sources of Chinese economic statecraft based on research in the political economy and international

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<sup>30</sup> Lampton, 79, 246–247; Shirk, *China: Fragile Superpower*, 24–34; David Shambaugh, "China Engages Asia: Reshaping the Regional Order," *International Security*, 29:3 (Winter 2004/05): 64–99; Keller and Rawski, ed. *China's Rise: and the Balance of Influence in Asia*; Bergsten et al, eds., *China's Rise: Challenges and Opportunities*.

<sup>31</sup> William Norris, "Thinking Clearly About China's Economic Statecraft," *Precis* (2009): 6–9.

<sup>32</sup> Ross, "Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia"; Medeiros et al., *Pacific Currents: The Responses of U.S. Allies and Security Partners in East Asia to China's Rise*.

relations fields. The intent is to lay the groundwork for the case studies. This part is deliberately broad in scope to address a range of internal factors shaping Chinese economic statecraft including Chinese grand strategy, domestic politics and industrial sector development. It describes structural conditions underlying asymmetric interdependence in Chinese economic statecraft based on two assumptions. First, certain types of asymmetric interdependence can support exercise of coercive levers in economic statecraft even if China is the relatively less developed economic power. Second, asymmetric interdependence can develop intentionally as an outcome of Chinese grand strategy or unintentionally due to side-effects of economic policies, such as consolidating value-added supply chains or pegging the renminbi (RMB) to the dollar. Either way, this asymmetric interdependence provides Beijing with coercive levers in economic statecraft. These levers can become viable policy options if and when situational factors allow Beijing to pursue desired policy objectives against a target state.

The second part of this study uses the case study method to investigate the role of coercive levers in Chinese economic statecraft. This part includes a major case and four mini-cases. The major case involves China's suspension of rare earth element (REE) shipments to Japan in response to a 2010 maritime incident that occurred in disputed waters in the East China Sea.<sup>33</sup> It is a clear example of coercive lever exercise to achieve multiple outcomes (e.g., economic, political and security). The first three mini-cases include the Sino-Korean garlic wars (1999–2000), the Sino-Japanese tatami mat wars (2001) and the Sino-American arms sanctions in response to U.S. arms sales to Taiwan (2010). While the Sino-Japanese case and the first two mini-cases feature examples of explicit lever exercise, the Sino-American mini-case features an example of implicit coercive lever exercise. The relevant question is whether China can pursue explicit exercise as a viable policy option against the United States, meaning a shift from threat to

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<sup>33</sup> Examples of international media, trade press, think tank, academic and U.S. government sources for rare earths are: Keith Bradsher, "China is Blocking Minerals, Executives Say," *The New York Times*, September 24, 2010; Cindy A. Hurst, "China's Rare Earth Industry: What Can the West Learn?" Washington D.C., Institute for the Analysis of Global Security (IAGS), March 2010; Robert Looney, "Recent Developments of a New Technocratic Mercantilism Emerging in China?" *World Economics* 12:1 (2011); U.S. Library of Congress, Congressional Research Service, *Rare Earth Elements: The Global Supply Chain*, by Marc Humphries, CRS Report R41347 (Washington, DC: Office of Congressional Information and Publishing, September 6, 2011).



action. The Sino-Japanese case is the heart of this study, given its clarity as an example of explicit coercive lever exercise in a security context. This study will compare findings across cases to determine if discernible patterns or key shifts offer general implications for Chinese economic statecraft.

Mention of Chinese economic statecraft in casual conversation often evokes Chinese efforts to strengthen economic exchanges with developing nations in Latin America, Africa and Southeast Asia. While China is itself still classified as a developing nation by the World Trade Organization, its economy is significantly larger than any country in these regions. As such, there are valid reasons for expanding research of coercive levers in Chinese economic statecraft beyond Northeast Asia. By focusing on the United States and Japan - the world's first and third largest economies - this study considers patterns of economic statecraft between large economic powers in which China plays the role of a developing state or a near peer competitor. The case studies feature asymmetric interdependence in specific sectors that provide Beijing with levers that become viable policy options in economic statecraft. These conditions apply even when China is a less developed economic power compared to the United States or a near peer competitor relative to Japan. Though China surpassed Japan as the second largest economy in 2010, trade relations remain relatively balanced, Japan's economy is more mature, and Japan's per capita GDP remains several times higher.

This study has three key findings. First, coercive lever exercise remains rare relative to inducements in Chinese economic statecraft. These application preferences are based on the convergence of Chinese grand strategy, foreign policy making and political economy trends. Second, in each of the cases, exercise patterns were reactionary and China relied on coercive levers derived from asymmetric interdependence with the target state. Beijing can and will exercise coercive levers in the context of a bilateral trade dispute or during select high-stakes international crises, but only to an extent that exercise supports limited political objectives such as signaling resolve, dispute resolution or altering specific behavior in the target state. Third, though reluctant to exercise coercive levers, China's capabilities are evolving and it is becoming a more confident practitioner that selects among an increasingly sophisticated range of policy options in

economic statecraft. As China continues to deepen integration with the global economy, coercive levers derived from asymmetric interdependence will likely proliferate.

The study is organized as follows. Each part has two chapters. Chapter II defines key terms and concepts, presents two hypotheses and reviews economic statecraft literature including sources specific to Chinese economic statecraft. Chapter III covers Chinese grand strategy and foreign policy making, an overview of Chinese political economy trends affecting economic statecraft, and a detailed description of China's rare earth sector. In part II, chapter IV examines the Sino-Japanese rare earth case, while chapter V treats comparative factors across the mini-cases. Chapter V concludes the study with a discussion of implications for the role of coercive levers in Chinese economic statecraft. In sum, part one of this study attempts to identify the causal factors that developed asymmetric interdependence in the cases. It then explains what China does with coercive levers in part two.

## **II. HIRSCHMANESQUE LOGIC, CHINESE CHARACTERISTICS**

### **A. INTRODUCTION**

This chapter introduces key terms, definitions and concepts in economic statecraft and describes recent research relevant to Chinese economic statecraft. The first section defines economic statecraft, asymmetric interdependence and implicit and explicit coercive levers as key terms used throughout this study. The next section describes the problems and hypotheses the study addresses: first (H1), China applies explicit coercive levers rarely, and instead prefers the flexibility of implicit coercive levers; second (H2), when China does apply explicit coercive levers, the intent is to achieve limited outcomes such as signaling resolve, official protest or short-term shifts in a target state's behavior. The chapter then begins a literature review, which covers classics in economic statecraft, Chinese economic statecraft in East Asia and Chinese economic statecraft in Sino-American relations. The last section describes concepts to isolate coercive levers in Chinese economic statecraft in stages: asymmetric, situational, exercise and effects.

### **B. TERMS AND DEFINITIONS**

#### **1. What is Economic Statecraft?**

Economic statecraft and international economic exchanges are not synonymous, particularly since exchanges can occur between autonomous economic actors. By definition, the state plays a leading role in economic statecraft, though it relies heavily on economic actors for implementation. And while international economic exchanges can exist without economic statecraft, establishing the former is a necessary precondition of the latter. Like all forms of statecraft, economic statecraft applies national instruments of power as means to influence political outcomes. Unlike other forms of statecraft, the means are economic. Beyond this broad definition, this study draws heavily from the influential work of Albert Hirschman and David Baldwin. Most analysis of economic statecraft begins with reference to Hirschman's 1945 classic, *National Power and the Structure of Foreign Trade*, in which he highlighted the political consequences of international trade through analysis of Hitler's political subordination of Eastern Europe

in the 1930s through asymmetric trade relations. He found that beyond the blunt mercantilism characteristic of 16–18<sup>th</sup> century Europe, trade during the interwar era (1918–1939) extended power politics in subtle, though nonetheless significant ways. The premise was simple: asymmetric trade relations have political consequences, particularly when a predatory state seeks more than wealth. It follows that, “a country trying to make the most of its strategic position of its own trade will try precisely to create the conditions that make the interruption of trade of much graver concern to its trading partners than to itself.”<sup>34</sup> Despite Hirschman’s enduring influence on the literature, he did develop the concept of economic statecraft in his research.

As such, this study builds upon Baldwin’s authoritative definition of this concept from his 1985 book, *Economic Statecraft*, as “influence attempts relying primarily on resources which have a reasonable semblance of a market price in terms of money.”<sup>35</sup> Specifically, this study adopts Baldwin’s “means-ends analysis” by folding the above definition of techniques into economic means.<sup>36</sup> By definition, economic statecraft involves exercise of economic levers such as sanctions, foreign aid or trade agreements by states to achieve policy goals. At least two states participate in economic statecraft: the sending state exercises the lever and the target state absorbs the effects. While these levers must be economic, the political objectives and desired outcomes, such as a change in a target state’s behavior, can be non-economic and still meet the criteria of economic statecraft.<sup>37</sup> For example, while China has resource interests in sub-Saharan Africa, it only provides aid to those countries that support its “One China” policy, normalizing relations with the People’s Republic of China (PRC) rather than Taiwan.<sup>38</sup> In sum, economic statecraft encompasses a range of economic levers applied deliberately “to get others to do what they would not otherwise do.”<sup>39</sup>

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<sup>34</sup> Hirschman, *National Power and the Structure of Foreign Trade*, 16.

<sup>35</sup> David A. Baldwin, *Economic Statecraft* (Princeton: Princeton University Press, 1985), 13–14. See tables 2 and 3 on pages 41–42 for an extensive list of potential levers.

<sup>36</sup> *Ibid.*, 16.

<sup>37</sup> *Ibid.*, 39–42.

<sup>38</sup> Deborah Brautigam, *The Dragon’s Gift* (New York: Oxford University Press, 2009); Lum, “China’s Foreign Aid Activities in Africa, Latin America, and Southeast Asia.”

<sup>39</sup> Brautigam, *The Dragon’s Gift*, 9.

## 2. What are Coercive Levers and Why Does Asymmetry Matter?

While all outcomes of economic statecraft are potentially coercive based on the above definition, not all levers are coercive. In fact, economic statecraft often strives to develop “influence effects” through application of non-coercive levers that function as economic inducements (e.g., foreign aid, licensing agreements), luring a target state toward the sending state’s desired political outcomes.<sup>40</sup> For example, attaching an annual aid package to bilateral free trade agreement (FTA) negotiations with a developing country creates both short and long-term incentives to sustain mutually beneficial economic exchanges. Over time, the sending state acquires political influence in the target state’s domestic politics, primarily through constituencies that have the most to gain from preserving an inducement. While influence effects matter, this study more concerned with the exercise of another kind of lever, namely coercive levers.

In all cases, this study refers to coercive levers as punitive measures (e.g., sanctions, embargoes, tariffs, and financial measures) applied or threatened in the context of bilateral asymmetric interdependence. Because there are different types of levers in economic statecraft, states must weigh the costs and benefits of selecting levers as viable policy options. It follows that as with all forms of statecraft, transaction costs have a direct bearing on decision-making in economic statecraft.<sup>41</sup> This definition borrows two additional concepts: asymmetry and explicit versus implicit coercion.

In the first concept, this study differentiates Hirschman’s asymmetric trade relations from Robert Keohane and Joseph Nye’s asymmetric interdependence. Though he did not use these precise terms, from a Hirschmanesque perspective, asymmetry develops between two trading nations if the smaller, poorer state has more at stake in the trade relationship than the larger, richer state. This asymmetry gives the larger state coercive leverage through either explicit or implicit threats to disrupt trade relations. In most cases, the smaller state yields because it cannot suspend trade in a given article or

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<sup>40</sup> The concept of influence effects, belongs to Hirschman. See also the discussion of sanctions and inducements in Jean-Marc F. Blanchard et al, “The Political Economy of National Security: Economic Statecraft, Interdependence, and International Conflict,” *Security Studies* 9:1–2 (199): 1–14.

<sup>41</sup> Baldwin, *Economic Statecraft*, 15.

alternative market transaction costs, including stockpiling and developing new supplies, are too high.<sup>42</sup> Larger states may also make economic concessions to increase the smaller state's dependence and to influence its domestic politics.<sup>43</sup> In contrast, Keohane and Nye argue asymmetry does not always favor larger, more powerful states. When this happens, it may reflect problems of power conversion between issue areas (e.g., military to economic) or the advantages of less powerful states under certain conditions of asymmetric interdependence.<sup>44</sup> Rather than antagonizing the more powerful state head on, these "states will try to use asymmetrical interdependence in particular groups of issues as a source of power."<sup>45</sup> Building on both approaches, this study argues less sophisticated economic powers can exploit conditions of asymmetric interdependence to exercise coercive levers in economic statecraft.

Explicit coercion involves official and/or observable actions to exercise levers punitively, while implicit coercion involves the threat to exercise levers punitively without necessarily taking action. Differentiating between explicit and implicit coercion poses an analytical challenge. Sanctions announced at a press conference may appear to be a clear example of explicit coercion, depending on whether the sending state follows through with action against its target. Implicit coercion does not reveal itself as easily and can occur during closed meetings between diplomats. The analyst then must assess if observable outcomes result from implicit coercion, often based on speculation and second-hand sources of dubious quality. Alternatively, implicit coercion may prove more normal than acknowledged, reflecting scholarly selection bias against coercive levers in general.<sup>46</sup> In fact, Drezner argues implicit coercion plays a key role in closed-door negotiations which can become manifest through game theory analysis. This study finds

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<sup>42</sup> Hirschman, *National Power and the Structure of Foreign Trade*, vii, x, xi, 30–31.

<sup>43</sup> Rawi Abdelal and Jonathan Kirshner, "Strategy, Economic Sanctions, and the Definition of National Interests," *Security Studies* 9:1–2 (1999): 119–156; See Jonathan Kirshner's summary in chapter 2 of the *Routledge Handbook of International Political Economy (IPE): IPE as a Global Conversation*, Mark Blyth, ed., (New York: Routledge, 2009).

<sup>44</sup> Keohane, and Nye, *Power and Interdependence*, 238–240.

<sup>45</sup> *Ibid.*, 242.

<sup>46</sup> Daniel W. Drezner, "The Hidden Hand of Economic Coercion," *International Organization* 57 (2003): 643–659. 644.

Drezner's approach compelling, but given the secrecy associated with Chinese diplomacy, does not expect sufficient evidence of this type of implicit coercive lever.

### **C. DIVINING CHINESE COERCIVE LEVER PREFERENCES**

This study addresses how China exercises coercive levers in the context of asymmetric interdependence. All forms of statecraft involve an interactive decision-making process of weighing various policy options and matching capabilities to desired objectives under domestic and international constraints. Outcomes represent the observable features of international relations. To the extent the data allow, analysis in this study focuses on the left side of this process, rather than on effects. Specifically, this study attempts to isolate the causal mechanisms driving Beijing's employment of explicit and implicit coercive levers in Chinese economic statecraft. It follows that if these conditions are understood, then analysts can make more accurate predictions on how, why and when China might apply coercive levers in the future.

This study will test two hypotheses on the role of coercive levers in Chinese economic statecraft (H1 and H2). First (H1), China applies explicit coercive levers rarely, and instead prefers the flexibility of implicit coercive levers. There are several potential explanations. Either China is not yet capable of applying explicit levers more frequently due to political economy constraints (e.g., uneven development, central-local politics, bureaucratic bargaining), or China is risk averse to political, military and economic consequences of applying explicit coercive levers. For example, application could undermine China's reputation management as a responsible power.

Second (H2), when China does exercise explicit coercive levers, the intent is to achieve limited outcomes such as signaling resolve, official protest or short-term shifts in a target state's behavior. It may be the type of asymmetric relationship producing the coercive lever constrains outcomes. More broadly, the comprehensive bilateral relationship between China and the target state also constrains application of coercive levers, particularly if China perceives that costs of continued exercise outweigh the benefits. It is also possible explicit exercise is an escalatory tactic, resulting if implicit exercise fails to achieve objectives. Another possibility is that China limits application

due to a lack of experience with coercive levers, and despite aspirations, cannot yet pursue more robust, long-term exercise.

## **D. LITERATURE REVIEW**

### **1. Classics in Economic Statecraft**

This study builds on economic statecraft literature from the International Relations sub-field of International Political Economy (IPE) by borrowing key definitions, theories and historical case studies underway since the mid-20<sup>th</sup> century.<sup>47</sup> Literature on Chinese economic statecraft emerged in the post-Cold War era, often focusing on how target states responded to China's economic rise and its increased presence as a foreign policy actor. Most of this literature focuses on the effects of Chinese economic statecraft rather than on its application. For this reason, and because actual examples of coercive levers in action are relatively rare, the data are limited and understudied.

This study contributes to the existing literature in two ways. First, it departs from Hirschmanesque logic in which smaller trading states are subordinate to larger trading states. Hirschman focused on the consequences of international trade relations during the mid-20<sup>th</sup> century when larger states had clear advantages. In contrast, this study considers how asymmetric interdependence in a particular sector can favor a near peer competitor or a less developed state under conditions of global interdependence. This approach does not dispute Hirschman's analytical framework. Rather it offers another way of thinking about asymmetry. If both states are relatively equal in terms of aggregate economic size, then sectorial asymmetry can tip the balance on the margins, creating disproportionate leverage in the affected sector. For example, while China surpassed Japan as the second largest economy in 2010, trade relations remain relatively balanced, and Japan's per capita GDP is much larger. Because Japan depends exclusively on China for REE imports, while China can diversify its exports, asymmetric interdependence exists in the REE sector. It does not exist elsewhere, but this condition

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<sup>47</sup> For an overview of IPE, see Mark Blyth, *The Routledge Handbook of International Political Economy (IPE): IPE as a Global Conversation* (New York: Routledge, 2009).



may be sufficient for the exercise of coercive levers. If one state has significantly more aggregate economic power, sectorial asymmetry can offer the weaker state pockets of coercive leverage. As the largest global economy, the United States plays the role of the larger state according to Hirschmanesque logic. Since it maintains massive trade deficits with a state that is also the largest foreign U.S. creditor, asymmetric interdependence exists with China across balance of payments issues.

Second, because the data is relatively limited on how China applies coercive levers in economic statecraft, this study analyses coercive lever exercise to improve understanding of the mechanism in play. As discussed above, this study draws definitions from two key texts, Hirschman's *National Power and the Structure of Foreign Trade* (1945) and Baldwin's, *Economic Statecraft* (1985). Successive generations of scholars have built on Hirschman's interwar case studies, and his argument that economic statecraft targets domestic constituencies who have a stake in maintaining dependent trade relations that undermine national interests. For example, Paul Papayoanou extended Hirschman, arguing a state's ability to balance against a perceived threat depends on the nature of its political institutions and economic ties.<sup>48</sup> These concepts relate to contention that coercive levers develop in stride with specific types of asymmetric interdependence. In part one, this study attempts to identify the causal factors that developed these asymmetries in each of the cases. It then explains what China does with coercive levers in part two.

Analysis of coercive levers as a mechanism within economic statecraft is based on Baldwin's comprehensive analysis of sanctions in *Economic Statecraft*. Baldwin challenges the denigration of economic statecraft among the press, academics and policy analysts (e.g., it does not work, therefore it does not matter).<sup>49</sup> Rejecting conventional focus on the success or failure of economic statecraft, Baldwin revisits historical cases

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<sup>48</sup> Paul A. Papayoanou, "Interdependence, Institutions and the Balance of Power: Britain, Germany, and World War I" *International Security* 20:4 (1996): 42–76. See also Paul A. Papayoanou, *Power Ties: Economic Interdependence, Balancing, and War* (Ann Arbor: The University of Michigan Press, 1999): 151–167; Kastner and Papayoanou, "Assessing the Policy of Engagement with China."

<sup>49</sup> For a more recent example of the critique, see Robert A. Pape, "Why Economic Sanctions Do Not Work," *International Security* 22:2 (1997): 90–136.

and applies a nine-point analytical framework that differentiates economic statecraft mechanisms (e.g., techniques, levers, goals, outcomes, costs).<sup>50</sup> The framework's separation of techniques (e.g., coercive levers) from desired outcomes (e.g., change in target state behavior) facilitates a more nuanced analysis of economic statecraft.<sup>51</sup> Baldwin spends considerable effort challenging 16 assumptions on the efficacy of economic sanctions (e.g., coercive levers), noting that sending states may pursue multiple desired outcomes simultaneously, including signaling resolve.<sup>52</sup> In testing H1 and H2, this study follows Baldwin's lead by analyzing how selection of coercive levers ties to desired outcomes in Chinese economic statecraft. By isolating coercive levers, this study also builds on Baldwin's emphasis on analyzing economic statecraft mechanisms, rather than privileging the outcomes.

Analysts continue to study economic statecraft using Baldwin's methodology. For example, Daniel Drezner argues that sanctioning states consider the likelihood of conflict with the target, are less likely to sanction allies despite higher success rates, and are more likely to sanction adversaries despite lower success rates.<sup>53</sup> This study is less concerned with the success or failure of coercive levers. As Baldwin notes, coercive levers do not need to achieve all desired outcomes to have a measurable effect, even if that effect is limited to support of another form of statecraft.<sup>54</sup> This study is however, interested in understanding Beijing's preferences and decision-making processes through testing H1 and H2.

## **2. The Rise of Chinese Economic Statecraft in East Asia**

Traditional China's economic role in East Asia dates back several millennia, marked by peaks of activity during the Song (960–1279 CE), Ming (1268–1644 CE) and

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<sup>50</sup> Baldwin, *Economic Statecraft*, 370–4.

<sup>51</sup> Jonathan Kirshner, "Economic Sanctions: The State of the Art," *Security Studies* 11:4 (2002): 160–179. See his discussion of Baldwin on pages 168–171.

<sup>52</sup> *Ibid.*, 177.

<sup>53</sup> Daniel Drezner, *The Sanctions Paradox: Economic Statecraft and International Relations* (Cambridge: Cambridge University Press, 1999); See also the book review in Jonathan Kirshner, "Economic Sanctions: The State of the Art," *Security Studies* 11:4 (2002): 160–179.

<sup>54</sup> Baldwin, *Economic Statecraft*, 205.

Qing (1644–1911) dynasties, in which China integrated into a vast network of global commerce.<sup>55</sup> This background matters not because those regimes have any meaningful resemblance to the CCP, or that China aspires to reassert the Middle Kingdom as some suggest,<sup>56</sup> but to acknowledge the deep historical roots of regional economic patterns. Because the PRC was largely isolated from participation in the global economy during most of the Cold War (~1950s–1970s), it lacked opportunities to develop the prerequisite political and economic ties to wield economic statecraft. Except for some interest in Chinese foreign aid activities in the developing world in the 1960–70s, the economic statecraft literature did not engage China meaningfully until its economic rise accelerated in the 1990s. Known as the second phase of reform, the period marked a transition from gradualism to “big bang” economic liberalization in which China deepened integration with the global economy. A process that promoted export-led growth through acquisition of best practices and technology transfers from abroad; it culminated with China’s accession to the World Trade Organization in 2001.<sup>57</sup>

Several analysts focus on the Hirschmanesque influence effects of Chinese economic integration and economic statecraft on balance of power politics in East Asia.<sup>58</sup> Given China’s growing economic exchanges in the East Asian region, analysts sought to understand whether economic statecraft increased the likelihood of military and political alignment with China (e.g., bandwagoning). For example, based on a 2010 quantitative study, Scott Kastner does not find a “consistent, statistically significant relationship between a country’s economic ties to China and that country’s willingness to

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<sup>55</sup> Rhoads Murphey, *East Asia: A New History* (New Jersey: Longman, 2010), 99–148.

<sup>56</sup> See David C. Kang, “Getting Asia Wrong: The Need for New Analytical Frameworks,” *International Security* 27:4 (2003): 57–85; for the counterpoint see Amitav Acharya, “Will Asia’s Past be its Future?,” *International Security* 28:3 (2003): 149–164.

<sup>57</sup> Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge: MIT Press, 2007): 100–110.

<sup>58</sup> Kahler and Kastner, “Strategic Uses of Economic Interdependence: Engagement Policies on the Korean Peninsula and Across the Taiwan Strait”; Kastner and Papayouanou, “Assessing the Policy of Engagement with China”; Medeiros et al., *Pacific Currents: The Responses of U.S. Allies and Security Partners in East Asia to China’s Rise*; Ross, “Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia”; Segal, “Chinese Economic Statecraft and the Political Economy of Asian Security.”

accommodate PRC interests.”<sup>59</sup> Adam Segal notes that short of political alignment, the reach of Beijing’s influence varies among developing states in Southeast Asia. Malaysia and Vietnam are not bandwagoning with China, but there is a growing tendency to check with Beijing before making commitments to other states.<sup>60</sup> Because this study focuses less on state responses to China’s economic rise, many findings do not apply directly to the role of coercive levers in Chinese economic statecraft. Instead, these sources are useful primarily as empirical background on Chinese economic exchanges in East Asia, and the ways in which deepening interdependence shapes Chinese economic statecraft preferences. As such, this section divides the literature into two parts: Northeast Asia and Southeast Asia.

*a. Chinese Economic Statecraft in Northeast Asia*

Certain patterns of Chinese economic exchanges in Northeast Asia inform tests of H1 and H2. For example, Robert Ross assesses the political impact of Chinese economic ties on secondary states – states that cannot independently defend themselves. Of the cases, the smaller economies of South Korea and Taiwan are increasingly dependent on the much larger Chinese economy, and are more likely to align with Chinese political preferences. Ross argues China’s economic influence over Taiwan and South Korea is primarily due to military dominance and geographic proximity, whereas Japan’s larger economy and military alliance with the United States shield it from dependency.<sup>61</sup> In broad Hirschmanesque terms, this assessment is probably correct, though Ross’s main interest remains in the effects of the military balance of power in East Asia. In other words, economic statecraft only matters under conditions of military superiority. This study argues asymmetric interdependence can facilitate access to coercive levers despite shifts in the military balance.

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<sup>59</sup> Kastner, “Buying Influence? Assessing the Political Effects of China’s International Economic Ties,” 13.

<sup>60</sup> Segal, “Chinese Economic Statecraft and the Political Economy of Asian Security,” 153.

<sup>61</sup> Ross, “Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia.”

Ross raises two of the rare examples of explicit coercive levers in Chinese economic statecraft during brief trade wars with South Korea and Japan, known as the Sino-Korean garlic wars (2000) and Sino-Japanese tatami mat wars (2001). Both examples demonstrate Hirschmanesque effects clearly in which sending state influence over a business constituency in the target state overpowered protectionist measures. In the garlic wars, China imposed import bans on South Korean mobile phone parts and polyethylene in retaliation for South Korean tariffs on Chinese garlic. Faced with \$100 million in losses, the South Korean mobile phone parts industry lobbied Seoul to drop the tariff, forcing the South Korean garlic industry to cede market share to China.<sup>62</sup>

In the tatami mat wars, both sides imposed high tariffs: Japan on Chinese leeks, shitake mushrooms, and reeds used to make tatami mats, and China on Japanese cars, air conditioners and cell phones. China incurred fewer relative costs because the value of Japanese products far exceeded the value of Chinese leeks. In response, Japan lifted the bans, avoided future trade wars and instead deepened economic integration with China.<sup>63</sup> As such, China became Japan's number one trading partner, and a crucial destination for Japanese investment and manufacturing. Yet this type of cooperation did not extend to political or military spheres due to the U.S.-Japan alliance and the relative size of Japan's economy.<sup>64</sup> These findings apply directly to this study. An asymmetric trade relationship allowed China to apply a coercive lever with limited consequences due to its cheaper exports. It turns out, China's exercise of the import ban had minimal economic impact on Japan. Because Japan relied on the Chinese market for its electronics, it could not sustain the long-term costs of coercive lever exercise. In fact, Japan reconsidered the viability of future import bans against China.

Like Ross, Segal argues China's relative military capability is an important factor in the development of political influence through economic statecraft. Unlike Ross, he argues the target state's domestic politics and threat perceptions are the

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<sup>62</sup> Ross, "Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia," 374–5.

<sup>63</sup> Ibid., 377.

<sup>64</sup> Ibid., 393.

main causal variables determining whether influence ultimately transfers. This is the case in Taiwan, but it is particularly evident in Japan. If the status quo of “cold politics, hot economics” continues, then Chinese economic statecraft will make little headway. Segal cites the 2005 Sino-Japan clash over natural gas exploration in the East China Sea and the subsequent anti-Japanese protests in China as examples of wayward nationalism. On the one hand, these events feed into Japan’s “China threat” school and its own nationalist sentiments to become a “normal” power. On the other hand, these events are examples of nationalism constraining the policy agenda and jeopardizing economic ties. If China wants to wield economic statecraft, it has to “balance nationalist sentiment... with the need to maintain stable economic relations.”<sup>65</sup> By describing how bilateral relationships shape economic statecraft preferences and application, these findings apply directly to tests of both H1 and H2 in the Sino-Japanese case study.

Evan Medeiros and his colleagues look at responses by Japan and five other states to Chinese economic growth and integration in East Asia, and like Ross, they do not find an increase in bandwagoning. Medeiros’ focus is on state responses to China, but bearing on H2, he suggests China avoids coercive lever application due to perceived political consequences. In fact, he notes, “when China tried to assert itself in such ways, its efforts have often been counterproductive, alienating its Asian interlocutors.”<sup>66</sup> Instead, China relies on passive influence to dissuade states from adopting containment strategies and to support China’s long-term reputation management. These considerations inform H1 predictions on Chinese preferences for implicit coercive levers first, and explicit coercive levers as a last resort per H2.

In a comprehensive survey of bilateral economic engagement involving North Korea, South Korea, the former Soviet Union, Taiwan and China, Miles Kahler and Scott Kastner evaluate constraining and transformative effects of interdependence. For example, while China failed to constrain Taiwanese domestic politics through enhanced cross-Strait economic exchanges, it apparently made some gains establishing a

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<sup>65</sup> Segal, “Chinese Economic Statecraft and the Political Economy of Asian Security,” 156.

<sup>66</sup> Medeiros et al., *Pacific Currents: The Responses of U.S. Allies and Security Partners in East Asia to China’s Rise* (Santa Monica, CA: RAND, 2008), Summary XVI.

pro-China coalition among Taiwanese elites.<sup>67</sup> Taiwanese businesses (e.g., the Taishing) are heavily invested in the Chinese mainland (~77%) and represent an important constituency in Taiwanese domestic politics. Given an economic stake in favorable cross-Strait relations, this coalition “tends to oppose foreign policy goals (like independence) that are starkly at odds with Beijing.”<sup>68</sup>

For Kahler and Kastner, regime type matters. The key question is whether democracies like Taiwan can manage competitive electoral politics and pursue credible foreign policies against authoritarian states like China. This survey underscores the risks of interdependence discussed in chapter I by demonstrating that transformative effects work both ways. On the one hand, democracies can socialize non-democracies to status quo norms through economic exchanges. This premise underscores the policy of engagement. On the other hand, authoritarian states can socialize democratic political constituencies through the same exchanges to develop a stake in favorable relations. These findings also support tests of H2 in which the domestic political balance in the target state weighs heavily on Chinese coercive lever preferences. This piece also reflects the accelerated movement of businesses from Taiwan to the mainland during the second phase of reform in ways that parallel movements from Japan.

#### ***b. Chinese Economic Statecraft in Southeast Asia***

This study references select literature on Southeast Asia to primarily to test H1 assumptions on the scarcity of coercive lever exercise despite prevailing conditions of Hirschmanesque relations. Because the Chinese economy is significantly larger than any economy in Southeast Asia, it is among the regions in which deepening Chinese economic integration appears to benefit China more than less developed Southeast Asian states. However, in this region a Chinese preference for inducements prevails over coercion (e.g., Hirschmanesque influence effects) an outcome chapter III will attempt to explain further. Though this study focuses primarily on the unanticipated consequences of sectorial asymmetric interdependence among more evenly matched

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<sup>67</sup> Kahler and Kastner, “Strategic Uses of Economic Interdependence: Engagement Policies on the Korean Peninsula and Across the Taiwan Strait,” 537.

<sup>68</sup> Ibid., 536.

economies, Southeast Asia remains a dynamic region in which the long-term effects of Chinese economic statecraft continue to evolve. Future research could focus on bilateral relationships in which China could change course and decide to pursue coercive lever exercise.

Research on Southeast Asian state responses to China's expanding economic integration in the region suggests a mixture of enthusiasm and wariness. States are eager to integrate with the Chinese market, but also challenged to become more productive. In fact, structural variance among Southeast Asia's ten economies creates different types of asymmetric interdependence with China that distribute influence in unexpected ways. For example, Evelyn Devadason finds that Sino-Southeast Asian trade expanded intra-regional trade, bolstered exports for some countries and enhanced integration with Chinese component assembly industries.<sup>69</sup> This appears to be a win-win outcome, except that some economies fair better than others.<sup>70</sup>

Kurlantzick's account of Chinese economic statecraft in Southeast Asia reflects conventional Hirschmanesque logic in which giant China wields significant political leverage over the sub-region's smaller states.<sup>71</sup> Consideration of China's foreign policy goals complicates this assessment. Because China seeks to reassure Southeast Asian nations of its peaceful intentions, it has so far been reluctant to employ coercive levers, and instead prefers economic inducements (e.g., foreign aid, FDI). Tempering alarmist accounts of China's charm offensive in Southeast Asia, Glosny argues positive aspects of Chinese economic statecraft improved Sino-Southeast Asian relations, but cautions that short and medium-term gains may not develop into a long-term trend.<sup>72</sup>

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<sup>69</sup> Evelyn S. Devadason, "ASEAN-China Trade Flows: Moving Forward with ACFTA," *Journal of Contemporary China* 19:66 (2010): 653–674; Cheng, Joseph Yu-Shek, "The ASEAN-China Free Trade Area: Genesis and Implications," *Australian Journal of International Affairs* 58, 2 (June 2004): 257–277.

<sup>70</sup> Yunhua Liu and Beoy Kui Ng, "Facing the Challenge of the Rising Chinese Economy: ASEAN's Responses," *Review of Development Economics* 14:3 (2010): 666–682.

<sup>71</sup> Kurlantzick, *Charm Offensive: How China's soft Power is transforming the World*.

<sup>72</sup> Michael Glosny, "Heading Toward a Win-Win Future? Recent Developments in China's Policy Toward Southeast Asia," *Asian Security* 2:1 (2006) 24–57; See also John Ravenhill, "Is China an Economic Threat to Southeast Asia," *Asian Survey* 46:5 (2006): 653–674.



Iain Coxhead argues Chinese demand for high-tech components and primary goods promotes a structural gap between the ASEAN-6 (Singapore, Malaysia, Indonesia, Thailand, the Philippines and Brunei) and the CLMV (Cambodia, Laos, Myanmar, Vietnam) economies by skewing development of these sectors. In the worst case, a resource curse could develop in which states dependent on primary goods trade with China lose incentives to promote further economic development. As a consequence, these states may ultimately deplete indigenous natural resources.<sup>73</sup> Like Coxhead, this study does not suggest that imposition of a resource curse results from a nefarious Chinese strategy. Beijing's primary interest in Southeast Asia involves advancing Chinese economic development. Instead, this study considers ways in which asymmetric interdependence increases the proliferation of coercive levers. The question for analysts, and future research in this region, is whether Beijing has the intent to exercise these levers coercively.

### **3. Chinese Economic Statecraft and the United States**

From a comparative historical perspective, this study draws from literature on U.S. economic statecraft in the 1980s-1990s and contemporary research on U.S. perceptions of the China economic threat. The findings support tests of H1 and H2 by revealing how patterns of economic and security interdependence between sending and target states shape coercive lever preferences. This section also offers potential explanations for why China is less reluctant to exercise coercive levers against Japan than against the United States, based on its own threat perceptions as a sending state and its awareness of "China threats" in the target state's domestic politics.

Michael Mastanduno notes that during the Cold War, U.S. academics and policymakers separated economic and security issues, matching the bipolar geo-political environment.<sup>74</sup> International political economy and security studies scholars pursued

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<sup>73</sup> Ian Coxhead, "A New Resource Curse?: Impacts of China's Boom on Comparative Advantage and Resource Dependence in Southeast Asia," *World Development* 35:7 (2007): 1099–1119.

<sup>74</sup> Michael Mastanduno, "Economics and Security in Statecraft and Scholarship," *International Organization* 52: 4 (1998): 825–854; Jean-Marc F. Blanchard et al, "The Political Economy of National Security: Economic Statecraft, Interdependence, and International Conflict," *Security Studies* 9:1–2 (1999): 1–14.

separate research agendas. U.S. security agencies subordinated economic agencies in the pursuit of foreign policy objectives. This issue bifurcation worked because, “the principal security challenger [the Soviet Union] was not an economic challenger, and the principal economic challengers [Japan and Europe] were security allies.”<sup>75</sup> A security-first approach shaped U.S. economic statecraft to an extent the United States granted significant economic concessions to target states to enhance security objectives. Here, the United States traded economics for security. As the next chapter will demonstrate, Chinese economic statecraft applies the inverse logic: it prioritizes economic exchanges ahead of security ties.

Mastanduno describes two relevant domestic political trends in the United States following the collapse of the Soviet Union and rise of globalization, when bifurcation began to unravel. First, a protectionist anti-Japan coalition dominated U.S. trade policy in the late 1980s and 1990s by bargaining successfully between security and economic stakeholders. Scholars, journalists, and Hollywood certainly contributed to these perceptions, reinterpreting research by Ezra Vogel and Chalmers Johnson.<sup>76</sup> Second, due to U.S. threat perceptions of Japanese competition, U.S. coercive levers proliferated in the form of punitive trade and monetary policies (e.g., pressure on Tokyo to revalue the yen), which ultimately faded when the Japanese economy entered stagnation in the 1990s.<sup>77</sup> Applying the above framework in this study, China has assumed Japan’s erstwhile role as the principle economic challenger to the United States, though no U.S.-China security alliance exists. In fact, the 2008 financial crisis and the ongoing global recession amplified scrutiny of China’s relative economic gains vis-à-vis the United

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<sup>75</sup> Mastanduno, “Economics and Security in Statecraft and Scholarship,” 839.

<sup>76</sup> Editorial “The Times and Japan Bashing,” *The Los Angeles Times*, October 10, 2007; Ezra F. Vogel, *Japan as Number One: Lessons for America* (Cambridge MA: Harvard University Press, 1979). Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford, CA: Stanford University Press, 1982).

<sup>77</sup> Mastanduno, “Economics and Security in Statecraft and Scholarship,” 842–3, 849. The coalition included members of Congress, USTR, the Dept. of Commerce, businesses and academics.

States.<sup>78</sup> Protectionist bills surged in the U.S. Congress and U.S. Republican presidential candidate, Governor Mitt Romney, vowed to declare China a currency manipulator his first day in office, a label with WTO consequences.<sup>79</sup>

Since China competes with both Japan and the United States as a non-ally, Papayouanou's research on balancing under conditions of interdependence and Drezner's sanctions paradox apply to Chinese coercive levers in this study. As Papayouanou argues, balancing against a perceived threat depends on a state's institutional context and its economic relations.<sup>80</sup> If states have extensive economic ties with a potential enemy, then it may be difficult to achieve sufficient domestic political consensus to balance credibly against a perceived threat. Underbalancing occurs instead.<sup>81</sup> The central argument of Drezner's Sanctions Paradox assumes that two factors inform state decisions to exercise coercive levers: target and sending state transaction costs; the likelihood of conflict. On the one hand, a state is more likely to sanction a non-ally if conflict dominates bilateral relations, but the likelihood of success is limited. On the other hand, a state may have difficulty sanctioning an ally due to closer political and economic ties (e.g. complex interdependence), though success is more likely for precisely the same reasons.<sup>82</sup>

These findings support this study's premise that the nature of interdependence between the sending and target state matters. At the very least, it impacts lever capacity and exercise preferences. Consistent with H2, this study goes further, asserting that Beijing is conscious of shifting domestic political trends within target states, including

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<sup>78</sup> Aaron L. Friedberg, "Implications of the Financial Crisis for the US-China Rivalry," *Survival* 52:4 (2010): 31–54; Nouriel Roubini, "China's Unsustainable Growth Model: The Rising Risk of a Hard Landing After 2013," *Roubini Global Economics*, August 17, 2011; Paul Krugman, "Will China Break?" *The New York Times*, December 18, 2011; Barry Naughton, "Macroeconomic Policy to the Forefront: The Changing of the Guard," *China Leadership Monitor* 36 (2012): 1–10.

<sup>79</sup> Mitt Romney's "How I'll Respond to China's Rising Power," *The Wall Street Journal*, February 16, 2012; Bonnie Glaser and Brittany Billingsley, "US-China Relations: US Pivot to Asia Leaves China Off Balance," *Comparative Connections* January (2012).

<sup>80</sup> Papayouanou, "Interdependence, Institutions and the Balance of Power: Britain, Germany, and World War I"; Papayouanou, *Power Ties: Economic Interdependence, Balancing, and War*.

<sup>81</sup> Randall L. Schweller, "Unanswered Threats A Neoclassical Realist Theory of Underbalancing," *International Security*, 29:2 (2004): 159–201.

<sup>82</sup> Drezner, *The Sanctions Paradox: Economic Statecraft and International Relations*; See also Jonathan Kirshner, "Economic Sanctions: The State of the Art," *Security Studies* 11:4 (2002): 160–179.

threat perceptions, and adjusts its economic statecraft accordingly. A follow-on question relates to the causal weight of these factors in the decision to exercise coercive lever exercise: how does Beijing balance its own threat perceptions of non-allies against exacerbating domestic political trends in the target state?

Interestingly, Kastner and Papayouanou argued in a 1998 study that the U.S. should continue engaging China because a high percentage of senior leadership benefitted from favorable trade relations (e.g. the pro-growth coalition). Risk would arise if ties deepened enough to limit alternative trade sources or if a pro-China constituency within the United States vetoed a balancing response to Chinese belligerence. Building on Hirschman's case study during the pre-WWI era, they cite Britain's failure to balance Germany in 1914 as a clear example. In Germany, Junkers and industrialists who were willing to risk war overpowered internationalist bankers, who were more concerned with maintaining trade ties. In Britain, internationalists vetoed strategists who wanted to contain Germany. In the Chinese case, "if the balance of power within China begins to shift toward inward-looking concerns, a revaluation of the policy of engagement would be in order."<sup>83</sup>

This study also draws from recent research on Chinese economic statecraft toward the United States that focuses on balance of payments issues (e.g., debt, currency policy, trade imbalances).<sup>84</sup> Drezner contends that observers exaggerate China's coercive leverage as the United States' largest creditor. Extensive Chinese interdependence with the United States and other economies prevents China from calling in its debts without incurring unacceptable financial and political costs. Here, debt lever exercise becomes synonymous with the nuclear weapons logic of Mutual Assured Destruction (MAD). This study concurs with Drezner's broad assessment, but contends China's incremental

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<sup>83</sup> Kastner and Papayouanou, "Assessing the Policy of Engagement with China," 19.

<sup>84</sup> Jean-Marc F. Blanchard, "China's Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China's Sovereign Wealth Fund and Renminbi Policies," *The Chinese Journal of International Politics* 4 (2011): 31–53; Drezner, "Bad Debts Assessing China's Financial Influence in Great Power Politics"; Kirshner, "The Consequences of China's Economic Rise for Sino-U.S. Relations: Rivalry, Political Conflict, and (Not) War."

application of the debt lever remains a plausible option for future coercive exercise.<sup>85</sup> Drezner also cautions if the U.S. cannot rein in its own fiscal policy, then “escalating U.S. budget deficits might shift the Sino-American financial relationship from mutual dependence to asymmetric dependence.”<sup>86</sup> This point supports the contention that economic exchanges can create forms of asymmetric interdependence with unanticipated consequences.

Kirshner analyzes Sino-American trade imbalances and U.S. protectionist pressure against China to revalue to RMB. Noting Yen revaluation contributed to Japanese stagnation since the 1990s, Kirshner predicts RMB revaluation will remain a persistent issue in the relationship, primarily because neither side can placate domestic and international stakeholders without incurring costs.<sup>87</sup> Risk arises, however, if either side fails to manage its protectionist coalitions. Similarly, Blanchard questions whether China’s Sovereign Wealth Fund (SWF) and RMB policies reveal coercive intentions. He argues both policies are driven by domestic growth and international prestige, implying Chinese economic statecraft pursues these outcomes simultaneously.<sup>88</sup> Taken together, these sources suggest China’s application of coercive levers in the U.S.-China trade relationship is not an immediate threat. This study argues that while China may not deliberately seek asymmetric interdependence with the United States, these capabilities develop in stride with economic policies. This effect increases China’s available levers (e.g., debt and RMB levers) without necessarily provoking coercive exercise.

## **E. IN SEARCH OF A COERCIVE LEVER PROCESS**

Parsing out a coercive lever process in Chinese economic statecraft poses analytical challenges. Again, a dearth of coercive lever examples exists for analysis, and scholars focus mainly on influence effects rather than processes. This study

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<sup>85</sup> *Caijing*, “China Cut U.S. Treasury Holdings for 3rd Straight Month,” February 16, 2012. <http://english.caijing.com.cn/2012-02-16/111684751.html>

<sup>86</sup> Drezner, “Bad Debts Assessing China’s Financial Influence in Great Power Politics,” 44.

<sup>87</sup> Kirshner, “The Consequences of China’s Economic Rise for Sino-U.S. Relations: Rivalry, Political Conflict, and (Not) War,” 245–6.

<sup>88</sup> Blanchard, “China’s Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China’s Sovereign Wealth Fund and Renminbi Policies,” 34.

conceptualizes coercive lever exercise along a spectrum of stages. First, the asymmetric stage outlines conditions of asymmetric interdependence in specific sectors. These sectorial asymmetries depart from the typical pattern outlined by Hirschman in which smaller states become dependent on larger states. Instead, coercive lever application is possible even when both states are relatively equal, or when the sending state has a less sophisticated economy than the target state. If both states are relatively equal in terms of aggregate economic size, then sectorial asymmetry can tip the balance on the margins, creating disproportionate leverage in the affected sector. If one state has significantly more aggregate economic power, sectorial asymmetry can offer the weaker state limited coercive leverage. In this stage, the key decision appointments involve either deliberate creation of a specific type of asymmetric interdependence through policy, or the opportunistic recognition that sufficient levels of asymmetric interdependence exist in a particular sector to make coercive leverage possible. Identification of coercive levers for economic statecraft completes this stage.

Second, the situational stage covers the opportunities to exercise coercive levers created when asymmetric interdependence with international politics converge. In this stage, strategic intent matters less than the political context in which China decides to exercise a coercive lever. That context can involve any international issue area. China could pull, or threaten to pull, a coercive lever over the price of garlic or an announcement of U.S. arms sales to Taiwan. Pairing levers to objectives is not an arbitrary process. Central-local relations and foreign policy-making trends inform domestic preferences. Management of China's reputation abroad, the military balance of power and economic exchanges shape preferences externally. As such, this stage analyses events that could trigger coercive lever selection and then looks at how China matches coercive levers with political objectives as these events unfold. For example, under what circumstances will Beijing decide to exercise a coercive lever in a non-economic issue area? What are the transaction costs of exercise? How long can Beijing sustain those costs? Which factors facilitate explicit exercise in one case, but constrain it in another? How is coercive lever exercise coordinated with other forms of statecraft

(e.g., military)? Selection of coercive levers against a target state along with clear political objectives completes this stage.

Third, the application stage covers how China exercises the coercive lever in economic statecraft. How does a coercive lever fit into the sequence of events in a given scenario (e.g., diplomacy first)? Does the lever support economic objectives, or does it crosscut issue areas? Is the lever explicit or implicit? How is intent to exercise the lever communicated to the target state? Who decides to exercise the coercive lever and how do orders travel from Beijing to the implementation point? Who are Beijing's agents in the field? This stage lasts for the duration of the coercive lever exercise. Fourth, the effects stage covers the extent that coercive levers achieve desired outcomes, including changing behavior in the target state. Desired political objectives are the starting point for this stage. Measurement of results comes next. For example, did exercise of the coercive lever accomplish desired political objectives, and if not, why not? If there were multiple objectives, which were met?

The main focus of this study, however, remains on how coercive levers work in economic statecraft, rather than on the effects of those levers. It follows that asymmetric interdependence creates coercive lever capabilities. Strategic, foreign policy making and political economy trends shape preferences. The nature of bilateral relations with the target state affects lever selection, exercise duration and achievable objectives. Situational factors driving the international event can trigger the decision to exercise levers implicitly or explicitly. Actual exercise depends on whether a specific lever is adequately matched with achievable policy objectives. Effects depend primarily on the target state, but also provide feedback to the sending state. To the extent possible, this study analyzes each of these stages within the cases. Finally, the study will attempt to find discernible patterns of coercion and related circumstances under which China might use coercive levers in the future. This study predicts that as China's integration with the global economy deepens, levers derived from asymmetric interdependence will become more prolific, presenting more opportunities for coercive exercise in economic statecraft.

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### **III. ECONOMIC DEVELOPMENT IS GRAND STRATEGY**

#### **A. INTRODUCTION**

This chapter addresses the domestic sources of Chinese economic statecraft from both political economy and international relations disciplinary perspectives. The intent is to lay the groundwork for the case studies by addressing the mechanics of economic statecraft within China and the structural conditions supporting asymmetric interdependence. This part treats the following basic questions as essential background information: How does economic statecraft interact with Chinese grand strategy? How do political economy trends affect China's capability to employ economic statecraft? Are economic policies with economic statecraft applications coordinated with foreign policy objectives? What are the key issue areas, stakeholders and sectors? How do asymmetries develop and what potential coercive levers evolve with them?

This chapter also corroborates H1 and H2, which predict that China exercises explicit coercive levers rarely based on a range of international and domestic factors. For example, long-term management of international prestige limits explicit exercise to reactionary crises, while central-local policy attenuation limits coercive lever capacity. In sum, this chapter addresses a key question: why are explicit coercive levers rare? Part of the answer is that along with China's economic rise, Chinese economic statecraft is a relatively new tool of national power. Beijing wields it conservatively. Making sense of how grand strategy and political economy trends interact with economic statecraft requires some essential background on China's economic rise.

#### **1. China's Rise: from Command to "Socialist Market Economy"**

In the years following establishment of the PRC in 1949, China adopted a Soviet-style command economy to catch up with Western industrialized economies. A state planning system substituted market signals and diverted agricultural surplus to capital-intensive industrialization and urbanization.<sup>89</sup> Initially this input-driven growth worked

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<sup>89</sup> Naughton, *The Chinese Economy: Transitions and Growth*, 55–57.

and China's GDP reached a respectable eight percent through the 1950s.<sup>90</sup> It flattened out as the agricultural sector stalled under the strain of increasingly inefficient heavy industries. Growth continued to decline due to a series of policy failures under Mao Zedong: millions starved during the autarky of the Great Leap Forward (1958–1961) while the Great Proletarian Cultural Revolution (1966–1976) turned Chinese society upside down.<sup>91</sup> At the same time, Cold War geopolitics isolated China from the Western economic system; its only trading partner was the Soviet Bloc. 1971–1972 marked a watershed as U.S.-China rapprochement and United Nations recognition allowed China to begin developing ties with the West and its allies.

After decades of political upheaval, Mao's successor, Deng Xiaoping recognized the CCP would not survive unless it could achieve rapid economic development and "deliver the goods" to a Chinese population disillusioned by Mao's ideological excesses.<sup>92</sup> He successfully wrestled the political initiative from vested elites at the Third Plenum of the Eleventh Central Committee held in December 1978 and codified this approach with the inauguration of "reform and opening" in 1979.<sup>93</sup> From then on in the reform era, CCP political legitimacy and regime survivability became intertwined with sustaining economic development.

Sinologists break the reform era into two phases. The first phase from 1979–1992 focused on unwinding the Soviet-style command economy by allowing a market sector to grow along side the state sector. This dual-track approach built political stability for further reform in the context of persistent bargaining between pro-growth and conservative factions.<sup>94</sup> Growth occurred "without losers," since income distribution was fairly equitable and living standards rose, particularly in the agricultural sector.

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<sup>90</sup> Naughton, *The Chinese Economy: Transitions and Growth*, 140.

<sup>91</sup> Ibid., 69–72.

<sup>92</sup> See for example, Kenneth Lieberthal, *Governing China: From Revolution Through Reform* (New York: W. W. Norton, 2004), 127–131.

<sup>93</sup> Ibid., 136.

<sup>94</sup> Susan L. Shirk, "Chinese Political Institutions and the Path of Economic Reforms," in *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993): 129–45; Naughton, *The Chinese Economy: Transitions and Growth*, 95; Qian Yingyi "How Reform Worked in China," in Dani Rodrik, ed., *In Search of Prosperity: Analytical Narratives on Economic Growth* (2003); 298–331.

Gradual integration with the global economy began in this phase as well, evidenced by Chinese membership in the International Monetary Fund and World Bank. Special Economic Zones (SEZ) in the coastal provinces brought in limited FDI, technology and best practices through the establishment of joint ventures with select multi-national corporations (MNC).

The second phase of reform began in 1993. It marked a key shift in Chinese elite politics toward “Big Bang” liberalization as China embraced the forces of globalization and export-oriented growth. This phase followed in the wake of the 1989 Tiananmen crisis and the 1991 demise of the Soviet Union, a highly contested period in Chinese politics in which conservative elites almost derailed the reform process.<sup>95</sup> Reinvigoration of reforms signaled a key political victory for the pro-growth coalition that persists today, despite periodic tensions.<sup>96</sup> In his last major policy initiative, Deng Xiaoping legitimized the shift to accelerated market-liberalization through the policy concept of a “socialist market economy.” Once again, reforms validated the relationship between economic development and CCP regime survivability.<sup>97</sup> Whereas the first phase sought to nurture domestic industries (e.g. import-substitution industrialization), the second phase looked increasingly for outward sources of growth. Domestic policies strengthened rational-legal governance by eliminating the dual-track system and restructuring the tax, banking, state-owned and legal sectors. Foreign trade reforms promoted Chinese exports and recast China as a business-friendly market for foreign investment.

Integration with the global economy deepened as massive FDI inflows brought MNCs, technology and best practices in exchange for access to Chinese labor, component

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<sup>95</sup> For the definitive account of elite politics from the first phase of reform through Tiananmen, see: Joseph Fewsmith, *Dilemmas of Reform in China: Political Conflict and Economic Debate* (Armonk, NY: M.E. Sharpe, 1994).

<sup>96</sup> Naughton, *The Chinese Economy: Transitions and Growth*, 69–88; Alice Miller, “Dilemmas of Globalization and Governance,” in *The Politics of China* (Third Edition), ed. Robert MacFarquhar (New York: Cambridge University Press, 2011), 528–599; Susan Shirk, *China: Fragile Superpower*.

<sup>97</sup> Lampton, *The Three Face of Chinese Power*, 79, 246–247; Shirk, *China: Fragile Superpower*, 24–34; David Shambaugh, “China Engages Asia: Reshaping the Regional Order,” *International Security*, 29:3 (Winter 2004/05): 64–99; William W. Keller and Thomas G. Rawski, ed. *China’s Rise: and the Balance of Influence in Asia* (Pittsburgh: University of Pittsburgh Press, 2007); C. Fred Bergsten et al., *China’s Rise: Challenges and Opportunities* (Washington D.C.: Peterson Institute for International Economics, 2009).

supply chains, and consumer markets.<sup>98</sup> Accelerated movement to China was underwritten by Chinese guarantees of responsible economic partnership. This process of “opening” culminated with China’s protracted accession to the World Trade Organization in December 2001, fifteen years after negotiations began to join the defunct Global Agreement on Tariffs and Trade (GATT) in 1986.<sup>99</sup> Here, past commitments to market-oriented reforms (e.g., reduction of tariff barriers) became formal obligations in exchange for access to international markets.<sup>100</sup> According to one analyst, accession went beyond opportunistic maximization of trade access; it represented “a comprehensive effort to “link up the rails” (*jiegui*) with the global economic system and to incorporate those norms within the domestic system.”<sup>101</sup>

Though this phase unleashed new development challenges, such as rising inequality and corruption, the combined results of both phases were impressive. China raised hundreds of millions from poverty and sustained an unprecedented growth rate of roughly 9.5% for more than thirty years.<sup>102</sup> It became East Asia’s primary manufacturing hub, integrating value-added supply chains and FDI inflows. Interdependence deepened due to rising demand from the EU, U.S. and Japan for Chinese exports. China’s global trade volume grew at a rate of roughly 14% annually, from less than one percent of global trade in 1980 to nearly 10% by 2010, when China became the world’s second largest economy.<sup>103</sup> In sum, China’s economic rise featured two key outcomes relevant for this study: the political primacy of economic development based

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<sup>98</sup> Bergsten et al., *China’s Rise: Challenges and Opportunities*, 360.

<sup>99</sup> “WTO Ministerial Conference approves China’s accession.” Accessed at: [http://www.wto.org/english/news\\_e/pres01\\_e/pr252\\_e.htm](http://www.wto.org/english/news_e/pres01_e/pr252_e.htm)

<sup>100</sup> Bergsten et al., *China’s Rise: Challenges and Opportunities*, 360. See also the China member page on the WTO website, accessed at: [http://www.wto.org/english/thewto\\_e/countries\\_e/china\\_e.htm](http://www.wto.org/english/thewto_e/countries_e/china_e.htm)

<sup>101</sup> Jeremy T. Paltiel, “Hinges and Latches on the Open Door: The Normative Parameters of China’s WTO Accession,” in *China’s Reforms and International Political Economy*, ed. David Zweig and Chen Zhimin (NY: Routledge, 2007): 131–151.

<sup>102</sup> Bergsten et al., *China’s Rise: Challenges and Opportunities*, 140.

<sup>103</sup> Loren Brandt, Thomas Rawski and Xiaodong Zhu, “International Dimensions of China’s Long Boom,” in *China’s Rise and the Balance of Influence in Asia*, ed. William W. Keller and Thomas G. Rawski (Pittsburgh: University of Pittsburgh Press, 2007): 15–46. See WTO data on China accessed at: <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=CN>

increasingly on integration with the global economy; the opportunities and constraints of that development for Chinese economic statecraft.

## **B. ECONOMIC STATECRAFT IN CHINESE GRAND STRATEGY**

Grand strategy is the state orchestration of all national instruments of power as means to achieve policy objectives aligned with national interests. The concept implies a degree of coordination between a state's diplomatic, information, military and economic powers, that in practice, is rarely possible.<sup>104</sup> Due to China's deepening economic integration with the global economy and its expanding economic exchanges, economic statecraft plays an increasingly important role in Chinese grand strategy. In a foreign policy context, these activities support efforts to assuage fears China's rise reflects anything less than "peaceful development" and to manage its global reputation as a "responsible major power" that promotes "win-win" cooperation abroad.<sup>105</sup> Consistent with H1, this section argues China is reluctant to apply explicit coercive levers that might undermine core elements of its grand strategy, including international reputation management. Instead, Beijing prefers non-coercive levers primarily, but presumably enjoys the flexibility of implicit coercive levers. This explanation partly addresses why examples of explicit coercive levers are relatively rare.

### **1. What is Chinese Grand Strategy?**

Given a preference for secrecy and party discipline among PRC leadership, divining Chinese grand strategy presents obvious challenges. Some analysts debate whether a Chinese grand strategy exists.<sup>106</sup> Over the past decade, transparency improved under President Hu Jintao with the routine release of select national policy documents (e.g., CCP Politburo meeting reports) and greater participation by Chinese academics in

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<sup>104</sup> Basil Henry Liddell Hart, *Strategy* (New York: Praeger, 1954).

<sup>105</sup> Shirk, "The Responsible Power" in *China: Fragile Superpower*, 105–139.

<sup>106</sup> Wang Jisi, "China's Search for a Grand Strategy A Rising Great Power Finds Its Way," *Foreign Affairs* 90:2 (2011), 60, 68. See also Aaron L. Friedberg, "'Going Out': China's Pursuit of Natural Resources and Implications for the PRC's Grand Strategy," *NBR Analysis* 13:3 (2006): 1–34.

open policy debates.<sup>107</sup> For example, Chinese academics often debate the concept of comprehensive national power (e.g., “coercive, economic and ideational power”) and how China should achieve it in the context of the international balance of power.<sup>108</sup> Compared with the United States, China lacks a comprehensive series of strategic documents (e.g., NSS, NDS and NMS). Augmenting its defense white paper series, Beijing came closest to an authoritative grand strategy with the release of its “peaceful development” white papers in 2005 and 2011.<sup>109</sup> The underlying concept evolved from a 2002 academic study commissioned by President Hu. Based on the defunct “peaceful rise” concept, peaceful development promoted China’s rise and sought to assuage perceptions of the China threat.

Unsurprisingly, the 2011 “peaceful development” white paper reiterated the primacy of economic development in Chinese grand strategy. “The central goal of China’s diplomacy,” it stated, “is to create a peaceful and stable international environment for its development.” This premise, based on more than thirty years of economic reforms, is central to both the study of Chinese economic statecraft and the relative weight of economic issues in Beijing’s political calculus. While national defense is integral to China’s territorial sovereignty and expanding global interests, it remains subordinate to economic development (e.g., last of the “four modernizations”)<sup>110</sup> For example, despite inflated estimates of the Chinese military budget, its growth rate is pegged to GDP growth.<sup>111</sup>

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<sup>107</sup> Alice Miller, “Dilemmas of Globalization and Governance,” in *The Politics of China* (Third Edition), ed. Robert MacFarquhar (New York: Cambridge University Press, 2011), 528–599. 579.

<sup>108</sup> See David Lampton’s summary of this debate, Lampton, *The Three Faces of Chinese Power: Might, Money, And Minds*, 20–23; For Chinese scholarship, see for example: Yan Xuetong, “The Rise of China and its Power Status,” *Chinese Journal of International Politics* 1 (2006): 5–33.

<sup>109</sup> Information Office of the State Council. The People’s Republic of China. *China’s Peaceful Development* (Beijing: September 2011). Accessed at: [http://english.gov.cn/official/2011-09/06/content\\_1941354.htm](http://english.gov.cn/official/2011-09/06/content_1941354.htm)

<sup>110</sup> The four modernizations are agriculture, industry, science and technology and national defense. Evan S. Medeiros, *China’s International Behavior: Activism, Opportunism and Diversification* (Santa Monica, CA: RAND, 2009): 50–51; See also, Information Office of the State Council, the People’s Republic of China, *China’s National Defense in 2010* (Beijing, China: March 31, 2011).

<sup>111</sup> Dennis J. Blasko, *The Chinese Army Today: Tradition and Transformation for the 21<sup>st</sup> Century* (New York, NY: Routledge, 2008), 12.

A rough consensus has emerged as scholars pieced together the main features of Chinese grand strategy through analysis of rhetoric, official sources and observable foreign policy behavior.<sup>112</sup> Analysts noted a key strategic shift in the mid-1990s. Beijing recognized rising suspicions of Chinese military and economic capabilities (e.g., the China threat) would force it to take a more active role in managing international perceptions.<sup>113</sup> Based on this shift, Avery Goldstein interpreted Chinese grand strategy as expanding “international clout without triggering a counter-balancing reaction.”<sup>114</sup> Goldstein describes two supporting components: 1) diplomacy to establish indispensable partnerships with major powers 2) campaigns to promote a positive reputation abroad, and to suppress pessimistic interpretations of Chinese economic and military capabilities. Other important strategic objectives include preserving internal security, maintaining territorial sovereignty and reunification with Taiwan.<sup>115</sup> Though analysts continue to debate whether Beijing aspires regional hegemony, increasing regional influence is a reasonable consensus goal that links back to the essential purpose of economic statecraft.<sup>116</sup> Beijing’s preference for inducements (e.g., influence effects) over coercion conforms to the broader strategic shift marked in 1996.

## 2. How Does Economic Statecraft Fit In?

Economic statecraft plays an increasingly important role in Chinese grand strategy by facilitating international conditions conducive to sustained economic

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<sup>112</sup> Avery Goldstein, *Rising to the Challenge: China’s Grand Strategy and International Security* (Stanford, CA: Stanford University Press, 2005); Glosny, “Heading Toward a Win-Win Future? Recent Developments in China’s Policy Toward Southeast Asia”; Lampton, *The Three Faces of Chinese Power: Might, Money, And Minds*; Shirk, “The Responsible Power” in *China: Fragile Superpower*; Blanchard, “China’s Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China’s Sovereign Wealth Fund and Renminbi Policies.”

<sup>113</sup> Goldstein, *Rising to the Challenge: China’s Grand Strategy and International Security*, 49–80.

<sup>114</sup> *Ibid.*, 12.

<sup>115</sup> Glosny, “Heading toward a Win-Win Future? Recent Developments in China’s Policy toward Southeast Asia”; Blanchard, “China’s Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China’s Sovereign Wealth Fund and Renminbi Policies”; Mikal E. Herberg, “The Rise of Energy and Resource Nationalism in Asia.” In *Strategic Asia 2010-11: Asia’s Rising Power and America’s Continued Purpose*, ed. Ashley Tellis et al. (Seattle: National Bureau of Asian Research, 2010), 112–140.

<sup>116</sup> Blanchard, “China’s Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China’s Sovereign Wealth Fund and Renminbi Policies,” 35.

development and by promoting China as a responsible major power abroad.<sup>117</sup> Based on limited success with military and political coercion in the 1990s, notably the 1995–6 Taiwan Straits crisis and 1995 Mischief Reef incident, Beijing has practical reasons to prefer inducements.<sup>118</sup> According to Adam Segal, economic statecraft advances four elements of Chinese grand strategy: 1) assuring resource access, 2) preventing the rise of an anti-China coalition, particularly among China's neighbors, 3) expanding Chinese prestige globally, 4) inducing Taiwanese reunification while deterring independence.<sup>119</sup> As noted in chapter I, the first of these elements arises in widely reported examples of Beijing's trade and foreign aid concessions in exchange for access to resources (e.g., oil and minerals) in the Middle East, Africa and Latin America.<sup>120</sup> One analyst calls this "resource diplomacy" a "mixed blessing" for Beijing, since it also attracts unwanted attention.<sup>121</sup> The second and third elements tie directly to limiting the impact of foreign policy conflict on economic development and promoting China's reputation, evidenced by the charm offensive in Southeast Asia. Though the fourth element focuses exclusively on Taiwan, the example of Beijing making aid in Africa contingent on explicit endorsement of its One China policy demonstrates how an element intertwined with Chinese sovereignty travels far outside East Asia.

Though China's economic rise began more than thirty years ago, Chinese economic statecraft did not play a meaningful role in its grand strategy until the late 1990s, mirroring the strategic shift noted above. This finding supports H2 contentions

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<sup>117</sup> Segal, "Chinese Economic Statecraft and the Political Economy of Asian Security," 148; Shirk, *China: Fragile Superpower*, 109.

<sup>118</sup> Medeiros et al., *Pacific Currents: The Responses of U.S. Allies and Security Partners in East Asia to China's Rise*, Summary XVI.

<sup>119</sup> Based on comments attributed to Adam Segal, "Workshop Report; Assessing China's Rise: Power and Influence in the 21<sup>st</sup> Century," Massachusetts Institute of Technology, Center for International Studies, (2009), 9.

<sup>120</sup> Friedberg, "'Going Out': China's Pursuit of Natural Resources and Implications for the PRC's Grand Strategy," 21–28; Kurlantzick, *Charm Offensive: How China's soft Power is Transforming the World*; Farnsworth, "The New Mercantilism: China's Emerging Role in the America's"; U.S. Library of Congress, Congressional Research Service, *China's Foreign Aid Activities in Africa, America, and Southeast Asia*, by Thomas Lum, et al., CRS Report R40361 (Washington, DC: Office of Congressional Information and Publishing, February 25, 2009); Moran, *China's Energy Strategy to Secure Natural Resources: Risks, Dangers, and Opportunities*.

<sup>121</sup> Friedberg, "'Going Out': China's Pursuit of Natural Resources and Implications for the PRC's Grand Strategy," 27.



that a lack of experience partly accounts for China's reluctance to exercise coercive levers. According to Ellen Frost, Beijing was initially hesitant to flex its economic power abroad.<sup>122</sup> Recognizing the rising value of intra-Asian trade in the wake of the 1997 Asian financial crisis, Beijing sought opportunities to deepen regional integration beginning with participation in the Chang Mai Initiative on currency swaps. As part of its charm offensive to counter the China threat in Southeast Asia, Chinese-led free trade agreements (FTA) proliferated with the ten-year implementation of the Association of Southeast Asian Nations (ASEAN) - China FTA (ACFTA). ACFTA signaled China's emergence as an activist economic actor increasingly willing to exercise "commercial diplomacy" abroad.<sup>123</sup> East Asian states responded to Chinese activism with a mixture of opportunism and wariness.<sup>124</sup> One analyst suggests these "low quality" FTAs could presage an exclusive East Asian trading bloc, threatening U.S. interests in the region.<sup>125</sup>

Aware of the international scrutiny accompanying its economic rise, Beijing takes great pains to assuage perceptions of the China threat in a target state's domestic politics, especially since those perceptions can spur protectionist policies that threaten Chinese export-led growth.<sup>126</sup> While China became a net oil importer in 1993, international scrutiny of Chinese oil demand spiked in 2004, creating the so-called "China energy threat theory."<sup>127</sup> In the United States, protectionist political pressure blocked Chinese acquisitions of U.S. oil companies, often fomented by commercial lobbies. In 2005, a Chinese oil company, China National Offshore Oil Corporation (CNOOC), withdrew its

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<sup>122</sup> Ellen L. Frost, "China's Commercial Diplomacy in Asia: Promise of Threat," in *China's Rise and the Balance of Influence in Asia*, ed. William W. Keller and Thomas G. Rawski (Pittsburgh: University of Pittsburgh Press, 2007): 95–117; See also, Glosny, "Heading Toward a Win-Win Future? Recent Developments in China's Policy toward Southeast Asia."

<sup>123</sup> Frost, "China's Commercial Diplomacy in Asia: Promise of Threat," 104–105.

<sup>124</sup> Devadason, "ASEAN-China Trade Flows: Moving Forward with ACFTA"; Cheng, "The ASEAN-China Free Trade Area: Genesis and Implications"; Liu and Ng, "Facing the Challenge of the Rising Chinese Economy: ASEAN's Responses"; Coxhead, "A New Resource Curse? Impacts of China's Boom on Comparative Advantage and Resource Dependence in Southeast Asia."

<sup>125</sup> C. Fred Bergsten, "China and Economic Integration in East Asia: Implications for the United States," Peterson Institute in International Economics, *Policy Briefs* PB07-3 (2007): 1-10.

<sup>126</sup> Shirk, *China: Fragile Superpower*, 247–251.

<sup>127</sup> Erica S. Downs, "China's Energy Rise," in Brantly Womack, ed., *China's Rise in Historical Perspective* (Lanham: Rowman and Littlefield, 2010): 171–200. 193.

\$18.5 billion bid to acquire Union Oil Company of California (UNOCAL).<sup>128</sup> If the perception of a state-backed acquisition sparked this level of protectionism, then coercive levers are even more likely to provoke domestic political backlash. Consistent with the discussion of the Japanese economic threat in U.S. domestic politics in the previous chapter, Beijing's concerns with protectionism are not without justification. In fact, between 2005–7 the U.S. Congress introduced 45 anti-China trade bills.<sup>129</sup> Clearly, this point corroborates H2, by highlighting the role of target state relations in lever selection.

The current “economics first, politics later,” approach to cross-Strait relations certainly reflects Beijing's practical shift away from overt forms of coercion.<sup>130</sup> It also aligns economic statecraft with reunification goals, though results are mixed.<sup>131</sup> Consistent with the literature reviewed in the previous chapter, Beijing has not found an effective way to convert economic exchanges into a hard domestic political constraint on Taiwan.<sup>132</sup> It may exert considerable influence over Taiwanese businesses heavily invested in the mainland (e.g., Taishing), but has not achieved consistent political results. For example, efforts to leverage Taishing as influence agents in Taiwanese domestic politics failed, mainly because Taishing interests did not align neatly with Beijing's reunification goals.<sup>133</sup> While maintaining economic exchanges presumably factors into Taiwanese policy considerations, the nature of cross-Strait interdependence also limits

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<sup>128</sup> Ironically, UNOCAL owned the Mountain Pass REE mine at the time of this acquisition. David Barboza and Andrew Ross Sorkin, “Chinese Company Drops Bid to Buy U.S. Oil Concern,” *The New York Times*, August 3, 2005.

<sup>129</sup> Drezner, “Bad Debts Assessing China's Financial Influence in Great Power Politics,” 33.

<sup>130</sup> See for example, Alan D. Romberg, “Taiwan Elections Head to the Finish: Concerns, Cautions, and Challenges” *China Leadership Monitor* 36 (2012).

<sup>131</sup> Romberg, “Taiwan Elections Head to the Finish: Concerns, Cautions, and Challenges”; Kahler and Kastner, “Strategic Uses of Economic Interdependence: Engagement Policies on the Korean Peninsula and Across the Taiwan Strait”; Murray Scott Tanner, *Chinese Economic Coercion Against Taiwan: A Tricky Weapon To Use* (Santa Monica, CA: RAND, 2007).

<sup>132</sup> Kahler and Kastner, “Strategic Uses of Economic Interdependence: Engagement Policies on the Korean Peninsula and Across the Taiwan Strait,” 536.

<sup>133</sup> Tanner, 103–132; William J. Norris, “Economic Statecraft with Chinese Characteristics: The Use of Commercial Actors in China's Grand Strategy.”

Beijing's ability to maintain a coercive political climate.<sup>134</sup> As scholar Yong Deng notes, "economic integration between Taiwan and Shanghai is probably higher than that between any two provinces."<sup>135</sup>

Though Chinese economic statecraft typically revolves around trade and aid levers, Beijing has pursued other levers with limited results. Once again, the relative novelty of China's economic rise partly accounts for Beijing's reluctance to pursue these levers more aggressively. While Beijing acquired several elements of global economic prestige in recent years, these tools did not convey instant expertise. With unprecedented holdings of nearly three trillion dollars in foreign currency reserves, Beijing created the China Investment Company (CIC) in 2007, a Sovereign Wealth Fund (SWF) to diversify Chinese investments abroad. Multi-billion dollar purchases are complicated transactions requiring a level of sophistication firms cannot develop quickly. As Blanchard notes, despite a \$300 billion endowment and expectations the CIC could shift the global financial balance, it made conservative investments to date.<sup>136</sup> The botched UNOCAL purchase illustrates an ongoing trend: in 2011 Chinese firms failed to make deals on international purchases valued at nearly \$39 billion.<sup>137</sup> These findings reinforce H2 by noting China's relatively limited experience as a major economic power constrains the exercise of certain levers, corroborating H2. Several analysts argue Beijing's RMB and debt levers do not offer much coercive leverage, though the situation could change.<sup>138</sup>

### **3. Economic Diplomacy or Economic Warfare?**

Analysis of official rhetoric offers additional insight into the relationship between economic statecraft and grand strategy. Three important policy concepts that evolved

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<sup>134</sup> Yong Deng *China's Struggle for Status: The Realignment of International Relations* (Cambridge: Cambridge University Press, 2008): 245–268; Segal, "Chinese Economic Statecraft and the Political Economy of Asian Security," 158–159.

<sup>135</sup> Deng, *China's Struggle for Status: The Realignment of International Relations*, 104.

<sup>136</sup> Blanchard, "China's Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China's Sovereign Wealth Fund and Renminbi Policies," 43.

<sup>137</sup> Nick Edwards, "Analysis: Politics, Patchy Past Hurt China Investment Hopes," *Reuters*, February 15, 2012.

<sup>138</sup> Drezner, "Bad Debts Assessing China's Financial Influence in Great Power Politics," 44; Kirshner, "The Consequences of China's Economic Rise for Sino-U.S. Relations: Rivalry, Political Conflict, and (Not) War," 245–6; Blanchard, 34.

from the strategic shift of the mid-1990s are “responsible major power,” “win-win cooperation,” and “peaceful development.”<sup>139</sup> Though none poses a hard constraint on Chinese foreign policy behavior, these concepts remain active in Beijing’s official lexicon to promote China as a responsible economic actor in the international system. In the early 2000s “economic diplomacy” entered official Chinese discourse, often in the context of enhancing economic exchanges with developing nations. From Baldwin’s perspective, this concept inflates the diplomatic role in economic statecraft at the expense of more comprehensive statecraft.<sup>140</sup> However, Chinese usage is consistent with the economic statecraft literature and fits with Beijing’s preference for inducements. There are also signs of official linkage of this concept to Chinese grand strategy. Following a national work congress on economic diplomacy held by the State Council in 2004, a *People’s Daily* editorial - among the most authoritative CCP propaganda tools - noted the importance of “strengthening coordination between economy and diplomacy.”<sup>141</sup>

The above emphasis on inducements through economic diplomacy contrasts with a less authoritative concept of “economic warfare.” In 1999, two PLA colonels, Qiao Liang and Wang Xiangsui, authored a commercial novel titled, *Unrestricted Warfare*. They argued China should pursue non-military forms of war against its adversaries, including “smuggling warfare (throwing markets into confusion and attacking economic order),” and “economic aid warfare (bestowing favor in the open and contriving to control matters in secret).”<sup>142</sup> By definition the concept of economic warfare is problematic, since using military means to achieve economic ends does not meet the criteria of economic statecraft.<sup>143</sup> If for example, the PLA employed cyber warfare to

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<sup>139</sup> Shirk, *China: Fragile Superpower*, 105–6, 128–9.; *People’s Daily*, “Premier Wen Calls for Win-Win Development Path for Asia,” November 2, 2003. Accessed at: [http://english.people.com.cn/200311/02/eng20031102\\_127404.shtml](http://english.people.com.cn/200311/02/eng20031102_127404.shtml).

<sup>140</sup> Baldwin, *Economic Statecraft*, 35.

<sup>141</sup> *People’s Daily*, “Editorial: Bright prospects for economic diplomacy with developing countries,” September 3, 2004. Accessed at: [http://english.peopledaily.com.cn/200409/03/eng20040903\\_155844.html](http://english.peopledaily.com.cn/200409/03/eng20040903_155844.html); See also, *People’s Daily*, “Intensive economic diplomacy rewrites trade pattern,” October 1, 2005. Accessed at: [http://english.peopledaily.com.cn/200510/21/eng20051021\\_215845.html](http://english.peopledaily.com.cn/200510/21/eng20051021_215845.html)

<sup>142</sup> Qiao Liang and Wang Xiangsui, *Unrestricted Warfare* (Beijing: PLA Literature and Arts Publishing House, February 1999), 55 [Foreign Broadcast Information Service (FBIS) translation].

<sup>143</sup> Baldwin, *Economic statecraft*, 36–38.

attack infrastructure and impose economic costs on the target state, then economic warfare would be an appropriate characterization. There are at least two more problems with the legitimacy of this source in the context of Chinese grand strategy. First, the PLA Literature and Arts Publishing House is part of the PLA's commercial wing; it publishes sensationalist books to generate revenue. Second, the PLA does not play an active role in Chinese economic statecraft, which the next section addresses in more detail. In sum, the concept of economic warfare does not appear to hold much weight in Chinese economic statecraft, which again supports H1 assumptions that Beijing is reluctant to exercise explicit coercive levers that conflict with broader objectives.

Despite these broad linkages, it remains unclear the extent to which grand strategy drives lever exercise during international events. The next section considers the intervening role of international politics and foreign policy making in tempering Beijing's exercise preferences. For example, though explicit coercive levers are rare, there are exceptions over the past decade in which Beijing opted for coercion. In support of H2, the relevant questions are the extent to which lever exercise is sequenced with grand strategy objectives and under what circumstances Beijing sees a shift from inducements to implicit or explicit coercion as a viable policy option. In other words, how does Beijing weigh transaction costs in economic statecraft? Consistent with Drezner's work on hidden coercion, this study expects that Beijing exercises implicit coercive levers behind closed doors more frequently than evidenced by the public record, but lacks sufficient evidence to support this claim.<sup>144</sup> Future research could apply game theory modeling and perhaps uncover examples of closed-door implicit coercive levers in Chinese economic statecraft.

### **C. CHINA AS A FOREIGN POLICY ACTOR**

This section frames the interactive relationship between economic statecraft, coercive lever preferences and Chinese foreign policy making. It builds on recent

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<sup>144</sup> Drezner, "The Hidden Hand of Economic Coercion."

research on China as a less than unitary foreign policy actor.<sup>145</sup> For example, Linda Jakobson and Dean Knox note three trends in a 2010 study.<sup>146</sup> First, foreign policy making may be increasingly contested by the rise of influential stakeholders with diverse policy agendas. For example, Chinese businesses play an increasingly important role as actors in Chinese economic statecraft. Large state-owned enterprises (SOE) in strategic industries (e.g., defense, oil) can shape foreign policy preferences on the margins in ways that might conflict with Beijing's interests, pursuing profit at the expense of central policy objectives.<sup>147</sup> International technological cooperation corporations (IETCC) execute infrastructure development projects abroad funded by Chinese foreign aid. Operated by provincial governments, IETCCs have a vested interest in promoting these initiatives to increase local growth.<sup>148</sup>

Second, while economic development remains a consensus priority, China's pro-growth coalition may not dominate policy indefinitely. This finding corroborates Kastner and Papayouanou's 1998 warning that engagement with China could run its course if the domestic political balance turns inward.<sup>149</sup> Third, advocacy for foreign policy activism is gaining traction in response to perceptions the United States and Japan are trying to contain China's rise. Relatedly, Susan Shirk argues Beijing allows popular expression of nationalism in response to foreign policy issues as a domestic political diversion, often manifested in sensationalist media reporting and Internet commentary.<sup>150</sup> Citing the 2005 anti-Japan protests as a key example, she argues that when state-sponsored nationalism adds a sense of urgency to Beijing's response to events involving Taiwan, the

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<sup>145</sup> Chinese foreign policy texts consulted for background information are: Lampton, *The Three Faces of Chinese Power: Might, Money, and Minds*; Marc Lanteigne, *China's Foreign Policy: An Introduction* (London and New York: Routledge, 2009); Robert S. Ross and Zhu Feng, ed. *China's Ascent*, (Ithaca: Cornell University Press, 2008); Shirk, *China: Fragile Superpower*.

<sup>146</sup> Linda Jakobson and Dean Knox, "New Foreign Policy Actors In China," Stockholm International Peace Research Institute (SIPRI) Policy Paper 26 (2010).

<sup>147</sup> *Ibid.*, 24–32.

<sup>148</sup> Linda Jakobson and Dean Knox, "New Foreign Policy Actors In China," 31–33.

<sup>149</sup> Kastner and Papayouanou, "Assessing the Policy of Engagement with China," 17.

<sup>150</sup> Shirk, *China: Fragile Superpower*, 85, 140–143.

United States and Japan.<sup>151</sup> In fact, Shirk argues that despite the long-term benefits of resolving historical grievances and territorial disputes with Japan, Beijing has “consistently sacrificed those interests in order to win domestic points for pressing symbolic issues.”<sup>152</sup> Obviously, this point bears directly on Beijing’s decision-making process in the Sino-Japanese case study, but it also suggests the role of public opinion in foreign policy making.

These findings have three relevant implications that suggest coercive levers could become more prominent in Chinese economic statecraft due to interactive patterns between domestic politics and international crises. First, in support of H1, foreign policy making complicates assumptions of a seamless transition from grand strategy to economic statecraft.<sup>153</sup> Even though Beijing improved articulation of its grand strategy through the increasingly routine release of various white papers, translating guidelines into coordinated foreign policy actions poses another problem set. Several levels of stakeholders and issue areas interact in response to international events. This process becomes highly pressurized during periods of international crises in which coercive levers are more likely to arise as viable policy options.

Second, despite a general preference for inducements in economic statecraft, reactionary scenarios could trigger Beijing’s decision to exercise coercive levers. Candidates include high-stakes international crises that provoke nationalist sentiments, such as bilateral incidents with Japan, Taiwan and the United States. In such cases, Chinese leadership would need to balance several competing priorities and choose policy options under significant pressure. Here, international reputation management may conflict the domestic political necessity to resolve crises expeditiously. At a minimum, selection of specific levers would depend on available capabilities, the nature of the dispute and the bilateral relationship with the target state. For these reasons, China may lack real bargaining power in trade negotiations with more developed countries, because

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<sup>151</sup> Segal, “Chinese Economic Statecraft and the Political Economy of Asian Security,” 157; Shirk, *China: Fragile Superpower*, 140–143.

<sup>152</sup> Shirk, *China: Fragile Superpower*, 148.

<sup>153</sup> Blanchard, “China’s Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China’s Sovereign Wealth Fund and Renminbi Policies,” 31–53.

the extension of political concessions might generate domestic costs China cannot afford without risking regime stability.<sup>154</sup> Here, explicit coercive lever exercise for short durations could support achievement of select political objectives by amplifying other crisis response efforts or by acting as a viable alternative to military escalation.

Third, different stakeholders can alter China's coercive lever preferences through domestic political bargaining, and what matters is how shifts in the internal balance of power alter domestic policy preferences.<sup>155</sup> Managing the inherent tensions between achieving economic growth and the threat of market liberalization to Leninist regime stability has persisted in elite Chinese politics since the reform era began in 1979.<sup>156</sup> If for example, the preeminent pro-growth political consensus does unravel among Chinese leadership, protectionist pressures could reshape the internationalist path of economic reforms and amplify the role of coercive levers in economic statecraft.

This outcome is not implausible. A sinologist recently argued if the Chinese economy shows signs of a soft landing (e.g., slowed growth without a recession) during the anticipated leadership transition in 2012, Chinese domestic politics could become increasingly contested and result in an erosion of consensus decision-making.<sup>157</sup> The frequency of trade wars in specific commodities, like the garlic and tatami mat wars, could increase either through Beijing's initiation or in response to protectionism in other states. Of interest is whether this frequency extends beyond the economic sphere. Beijing could impose export sanctions or other types of coercive levers in response to disputes across foreign policy issue areas. This study contends that making the leap across issue areas represents a key shift in Beijing's coercive lever exercise, an argument developed further in the next chapter.

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<sup>154</sup> Segal, "Chinese Economic Statecraft and the Political Economy of Asian Security," 154.

<sup>155</sup> Kahler and Kastner, "Strategic Uses of Economic Interdependence: Engagement Policies on the Korean Peninsula and Across the Taiwan Strait," 528; Kastner and Papayouanou, "Assessing the Policy of Engagement with China," 17.

<sup>156</sup> Joseph Fewsmith, "The Politics of Economic Liberalization: Are There Limits?" in *China's Rise And The Balance of Influence in Asia*, 74–94.

<sup>157</sup> Alice L. Miller, "Prospects for Solidarity in the Xi Jinping Leadership," *China Leadership Monitor* 37 (2012): 1–12; Keith Bradsher, "China Output Slows Sharply; Ripples Feared," *The New York Times*, May 25, 2012, A1; Kirshner, 256.



Several levels participate in Chinese foreign policy making, adding complexity to the process of lever selection in economic statecraft during international disputes. While this study is unaware of evidence that specifically describes an economic statecraft context, recent research has improved understanding of foreign policy making during crises.<sup>158</sup> A preference for consensus decision-making drives coordination at the top. Here, the CCP general secretary (e.g., Hu Jintao) triple-hatted as the PRC president and chairman of the Central Military Commission (CMC), also chairs the Politburo Standing Committee (PBSC), which is China's top decision-making body. Below this level, several key advisors, agency representatives and permanent issue teams, known as Leading Small Groups (LSG), form ad hoc working groups in response to international crises.<sup>159</sup> Next, the Ministry of Foreign Affairs (MFA) automatically establishes smaller crisis teams to coordinate with lower level bureaucracies and provide council to the PBSC in support of consensus decision-making.<sup>160</sup> Based on this general organizational outline, important bureaucratic actors in Chinese economic statecraft would include the Foreign Affairs Leading Small Group (FALSG), various ministries in Beijing (e.g., MFA, MIIT, MOFCOM), provincial government officials and SOEs.

Participation by other actors and their role in coercive lever selection would depend on the issue area and the other states involved. The role of military influence in lever selection occasionally arises in implicit coercive lever examples that do make international headlines. For example, exercise of coercive levers in a Taiwan dispute would require coordination with the Taiwan Affairs Leading Small Group (TALSG), in which the PLA is well represented.<sup>161</sup> As noted, Beijing avoids coercive levers in cross-strait relations (at least explicit ones) and has a shaky record influencing Taiwanese domestic politics. Nor is the PLA, a military tool, in control of economic means,

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<sup>158</sup> Michael D. Swaine, *The Role of the Chinese Military in National Security Policy Making* (Santa Monica, CA: RAND, National Defense Research Institute, 1998); Michael D. Swaine, "China's Assertive Behavior Part Four: The Role of the Military in Foreign Policy," *China Leadership Monitor* 36 (2012): 1–17; Kenneth Lieberthal, *Governing China: From Revolution through Reform*, 215–233.

<sup>159</sup> Swaine, "China's Assertive Behavior Part Four: The Role of the Military in Foreign Policy."

<sup>160</sup> *Ibid.*, 4–5.

<sup>161</sup> Jakobson and Knox, "New Foreign Policy Actors In China," 12–16; Swaine, "China's Assertive Behavior Part Four: The Role of the Military in Foreign Policy," 6.

particularly since its 1998 withdrawal from most extra-budgetary sources of income.<sup>162</sup> For that matter, the degree of PLA influence on foreign policy issues remains debatable.<sup>163</sup> If at all, the PLA could presumably influence desired political objectives during a crisis with Taiwan, rather than specific lever selection.

Interestingly, a group of retired PLA officials affiliated with National Defense University (NDU) and the Academy of Military Sciences (AMS) commented publicly that China should impose sanctions against the United States in response to the 2010 announcement of U.S. arms sales to Taiwan. According to *The Washington Times*, retired Major General Luo Yuan, affiliated with AMS, argued Beijing should respond by “dumping some U.S. government bonds” in a television interview.<sup>164</sup> Though think tanks like AMS do play an advisory role during crises,<sup>165</sup> it is not clear if Beijing directed these public comments. The comparable analogy would be a retired two star general critiquing the U.S. response to an international crisis as a military analyst on cable television. This study argues sanctions announced by MFA against U.S. arms companies offer a far more credible example of an implicit coercive lever, though Beijing apparently did not follow through on this threat.<sup>166</sup>

#### **D. POLITICAL ECONOMY TRENDS IN ECONOMIC STATECRAFT**

This section argues that Chinese economic statecraft is both empowered and constrained by political economy trends derived from China’s economic rise.<sup>167</sup> On the one hand, rapid economic growth presents Beijing with opportunities to promote influence abroad through economic statecraft. Accelerated liberalization since the 1990s allowed proliferation of levers Beijing is uniquely positioned to exercise due to

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<sup>162</sup> Andrew Scobell, “China’s Evolving Civil-Military Relations: Creeping Guojiahua,” *Armed Forces and Society* 31:2 (2005): 227–244. 235.

<sup>163</sup> Shirk, *China: Fragile Superpower*, 69–72; Michael Kiselycznyk & Philip Saunders, “Civil-Military Relations in China: Assessing The PLA’s Role in Elite Politics,” *INSS China Strategic Perspectives* 2 (2010): 1–39.

<sup>164</sup> Bill Gertz, “Chinese See U.S. Debt As Weapon in Taiwan Dispute,” *The Washington Times*, February 10, 2010.

<sup>165</sup> Swaine, “China’s Assertive Behavior Part Four: The Role of the Military in Foreign Policy,” 7–8.

<sup>166</sup> Keith Bradsher, “U.S. Deal With Taiwan Has China Retaliating,” *The New York Times*, January 31, 2010, A15.

<sup>167</sup> Segal, “Chinese Economic Statecraft and the Political Economy of Asian Security.”

conditions of asymmetric interdependence with target states. On the other hand, when China's development challenges combine with strategic and foreign policymaking constraints, the options for more aggressive economic statecraft narrow. As Adam Segal notes, "pursuing political objectives at the cost of shorter-term economic goals requires a fairly stable and mature economy as well as the ability to balance the demands of competing domestic interests."<sup>168</sup> Conditions of asymmetric interdependence might buffer aggregate level shortfalls in Chinese economic statecraft, but several situational factors must align for coercive lever exercise to become a viable policy option. Taken together, these points suggest Beijing cannot exercise coercive levers effectively if economic statecraft objectives conflict with development priorities.

In many respects, Beijing confronts an apparent embarrassment of riches in its economic statecraft due to its transition from command to market economy. A massive market economy governed by a Leninist state might appear to be an incredible advantage in economic statecraft. Prominent among Beijing's critics, Derek Scissors argues, "market reform has died out in China," due to the Hu-Wen preoccupation with GDP growth and market-distorting restructuring efforts.<sup>169</sup> According to this view, if the state controls strategic economic sectors then it should have less difficulty extracting resources and pursuing mercantilist policies abroad. The persistence of Leninist institutions (e.g., *nomenklatura*) undermines corporate governance and facilitates public-private collusion when provincial officials receive CCP appointments as SOE executives based on political criteria.<sup>170</sup> Backed by the moral hazard of non-performing loans (NPL), Chinese SOEs undermine global competition by assuming more risks than market-oriented multinational corporations. Scrutiny of China's energy strategy and the failed UNOCAL purchase are prime example of how this logic affects national perceptions of Chinese companies.

Though not entirely false, the assumption of state primacy loses strength in a domestic political context. Three stages illustrate this point. First, at an elite level,

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<sup>168</sup> Segal, "Chinese Economic Statecraft and the Political Economy of Asian Security," 154.

<sup>169</sup> Derek Scissors, "Deng Undone," *Foreign Affairs* 88:3 (2009): 24–40.

<sup>170</sup> Qian, "How Reform Worked in China."

economic policies are subject to bureaucratic and factional competition in Beijing during formation. Second, policy directives are tempered by devolving central-local relations during implementation.<sup>171</sup> Here provincial and local officials often ignore central directives in pursuit of “growth at any cost,” which accelerated during the second phase of reform.<sup>172</sup> Third, when policies finally interact with the market, Chinese commercial actors may define interests narrowly, further undermining governance through overt and subtle forms of non-compliance.<sup>173</sup> In fact, commercial actors underwritten by the moral hazard of locally issued NPLs typically benefit at the expense of the state, and are hardly an asset in Beijing.<sup>174</sup> Each of these successive stages cuts away at the assumption of central control over the economy. Several of these patterns share features with foreign policy making discussed in the previous section (e.g., elite bargaining). Individual provinces may participate in direct economic exchanges abroad through IETCCs, but Beijing still dominates international crisis response. Both trends corroborate H1 assumptions that domestic and international factors constrain Chinese economic statecraft.

Despite more than 30 years of unprecedented economic growth, China’s broader development challenges prevent it from assuming risk in economic statecraft at the expense of other priorities. Wide development gaps exist between urban and rural areas, coastal and inland provinces, and between export and consumer industries.<sup>175</sup> Coercive lever exercise could widen these gaps in ways that impact development and raise the risk of social unrest. For example, due to Beijing’s emphasis on export-led growth, exporters represent China’s most productive industries and are deeply integrated into global markets. If Beijing imposes an export ban on a Chinese-made product, the longer the ban

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<sup>171</sup> Susan L. Shirk, “Chinese Political Institutions and the Path of Economic Reforms,” in *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993): 129–45.

<sup>172</sup> C. Fred Bergsten et al., “Center-Local Relations: Hu’s in Charge Here?” in *China’s Rise: Challenges and Opportunities*, 9–32.

<sup>173</sup> Jakobson and Knox, 24–6; William Norris, a PHD candidate at the Massachusetts Institute of Technology (MIT), published a dissertation in late 2010 on the role of principal-agent dynamics in Chinese economic statecraft. William J. Norris, “Economic Statecraft with Chinese Characteristics: The Use of Commercial Actors in China’s Grand Strategy,” Ph.D. diss., Massachusetts Institute of Technology, 2010.

<sup>174</sup> David Barboza, “A Conversation With Carl Walter,” *The New York Times*, January 17, 2011.

<sup>175</sup> Bergsten et al., *China: The Balance Sheet*, 29–39.

lasts, the greater the risk to commercial profits, family livelihoods, local revenues and international market share. Meanwhile, an import ban could disrupt regional supply chains, reducing productivity. Though the Chinese legal system made great strides during the reform-era, the rule of law remains relatively weak with respect to private property rights, intellectual property protection and environmental regulatory compliance.<sup>176</sup> Coercive lever exercise that relies on regulatory compliance at the local level will probably stumble during execution. For example, enterprises may evade an export ban by shifting to black market operations. In sum, Beijing must weigh the costs associated with various levers and adjust exercise accordingly in economic statecraft.

Consistent with H1 and H2, this study argues these trends impose two potential limits on coercive lever exercise: 1) the duration of time Beijing can exercise the lever; 2) the scope of achievable political objectives. In theory, the target state bears the brunt of coercive lever exercise in economic statecraft, but in practice Beijing remains wary of exacerbating domestic tensions that could undermine regime stability. From Beijing's perspective, economic development challenges increase the likelihood of leadership splits at the top and widespread social unrest from below.<sup>177</sup> Picking up where the reform era discussion left off earlier in this chapter, recentralization initiatives since the 2000s reflect renewed policy emphasis on redistributive, sustainable growth. This shift is evident in President Hu's "scientific development concept" and "new socialist countryside."<sup>178</sup> Policies include a new round of SOE sector reforms (e.g., "grasp the large, release the small) along with bureaucratic reorganizations (e.g., SASAC, NDRC) to improve central oversight and industrial policy implementation.<sup>179</sup> These efforts also reflect the latest consensus between the pro-growth and conservative coalitions.

The next section describes China's dominance of the REE sector the development of sectorial asymmetry in the REE sector that allowed Beijing to exercise the REE ban as

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<sup>176</sup> Jerome A. Cohen, "China's Reform Era Legal Odyssey," *Far Eastern Economic Review* December (2008): 34–38.

<sup>177</sup> Shirk, *China: Fragile Superpower*, 52–69.

<sup>178</sup> Miller, "Dilemmas of Globalization and Governance," 584–589.

<sup>179</sup> Margaret M. Pearson, "Governing the Chinese Economy: Regulatory Reform in the Service of the State," *Public Administration Review* July/August (2007): 718–730.

a coercive lever against Japan. As the major case in the study, the REE sector receives disproportionate attention in this chapter compared with the four mini-cases. Chapter IV describes relevant conditions of asymmetric interdependence for the mini-cases.

## **E. CHINA'S RISE IN THE REE SECTOR**

This study highlights two outcomes that evolved as unintended consequences of Chinese REE dominance over several decades. First, sectorial dominance created the structural conditions for asymmetric interdependence with Japan, which depends heavily on Chinese REE imports (~90%). Second, this asymmetry contributed a coercive lever to Chinese economic statecraft, ultimately exercised in support of limited political objectives across issue areas. Though both outcomes were serendipitous in the context of economic statecraft, this study cannot conclude from the evidence that China sought dominance of the sector for coercive purposes. Instead, China's REE sector developed gradually as a consequence of evolving economic policies that began during the command economy and continued through the reform era. Recognition of the strategic value of REEs, as an agent of economic growth, dates back to the sector's 1950s origins.

Early establishment of an R&D base coupled with industrial policies to stimulate the domestic sector over several decades suggest Beijing anticipated the political value of REEs as a coercive lever early on. Whether or not 1950s planners figured this out is beyond substantiation, and in some respects, irrelevant to this study. Certainly, Beijing actively pursued REE technologies to promote domestic research and development. Production of quality REE-derived products that met international export standards was the ultimate goal. Regardless of when Beijing recognized its potential, the REE lever did not develop as a viable policy option until asymmetric interdependence deepened with Japan in the years following China's 2001 WTO accession.

Based on the early implementation of REE-related economic policies, Beijing viewed the REE sector as a strategic industry that supported broader economic development priorities. The REE industrial trajectory approximated China's progression from heavy industry in the command economy to advanced technology in its socialized market economy. Initial growth occurred alongside the steel industry, and in fact REEs

were literally a by-product of mined steel ore. Industrial policies in the 1980s promoted domestic mining capacity consistent with import-substitution industrialization (ISI) during the first phase of reform. REE sector trends in the 1990s supported the policy of “opening up” in the second phase of reform, including acquisition of best practices from foreign MNCs, vertical integration of value-added supply chains and development of indigenous innovations.<sup>180</sup> Taken together, these policies promoted export-oriented industrialization (EOI) from component assembly to research and design. Recentralization initiatives since the 2000s reflected renewed policy emphasis on sustainable growth consistent with President Hu’s “scientific development concept” and “new socialist countryside.”<sup>181</sup>

### **1. What are Rare Earths?**

Until the 2010 Senkakus case, rare earths were commonly associated with geologists, rather than geopolitics. Rare earth is actually a misnomer. In fact many of the 17 elements are found in abundant quantities globally, what makes them “rare” is that “they are rarely concentrated in mineable ore deposits.”<sup>182</sup> While China produces most of the global REE supply, REE reserves also exist in the United States, Australia, Canada, Brazil, India and South Africa. Long used as catalysts in heavy and chemical industries, REEs are also essential to the manufacture of key components in many advanced, dual-use and green technologies from computers to wind powered turbines, hybrid car batteries to laser guided bombs. In sum, REEs are vital to heavy industry and to thousands of high technology applications in the global economy.<sup>183</sup>

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<sup>180</sup> Brandt, Rawski and Zhu, “International Dimensions of China’s Long Boom.”

<sup>181</sup> Miller, “Dilemmas of Globalization and Governance,” 584–589.

<sup>182</sup> U.S. Geological Survey, “Rare Earth Elements-Critical Resources for High Technology,” Factsheet 087-02 (2002). Accessed at: <http://pubs.usgs.gov/fs/2002/fs087-02/>

<sup>183</sup> For additional background information on rare earths, see: Lee Levkowitz, “China’s Rare Earths Industry and its Role in the International Market,” *U.S.-China Economic and Security Review Commission Staff Background*, November 3, 2010; U.S. Department of the Interior (DOI), Geological Survey (USGS), “Rare Earth Elements-Critical Resources for High Technology,” *Fact Sheet* 082–02 (2002); U.S. Department of the Interior (DOI), Geological Survey (USGS), “Rare Earths” Mineral Commodity Summaries January (2012); U.S. Department of the Interior (DOI), Geological Survey (USGS), “Rare Earths” 2009 Minerals Yearbook July (2009): 6001–6015.

On the periodic table, REEs are atomic numbers 57–71 along with scandium (21) and yttrium (39). Based on atomic weight, these are divided into light and heavy REEs. More abundant are the light REEs, like neodymium, a catalyst widely used in petroleum and auto industries, while a heavy REE, like dysprosium, is the primary metal in permanent magnets, vital to the miniaturization of electronics. Extraction and processing are costly, both in terms of the potentially low return on investment along with high environmental costs. Many of the waste products are radioactive. REEs are found in mozanite or bastnaesite mixed in with mined ore. To get at the REE in bastnaesite, for example, ore is crushed to gravel, ground to powder and skimmed off the top of treated flotation pools. Acids and solvents then separate various REEs into oxides (REO), which are processed into metals and/or refined into alloys for use in high tech applications. This process takes roughly ten days.<sup>184</sup> In contrast, it can take roughly ten years from discovery of an REE source before mining is possible.<sup>185</sup>

## **2. How did China Dominate the Global REE Supply Chain?**

China's REE industry predates the PRC to the 1927 discovery of REE reserves in Baotao, Inner Mongolia. Extraction began in the 1950s with the recovery of REE-enriched bastnaesite ore as a byproduct of iron ore mining. Today the industry accounts for about 95% of global mining and oxide production along with approximately 50% of known reserves, about 55 million tons.<sup>186</sup> Its Bayan Obo mine in Baotao is the world's largest producer, though there are more than 100 enterprises scattered across nearly all of China's 22 provinces. Recognizing the industrial value of REEs as a catalyst, a research and development (R&D) base followed with establishment of the General Research Institute for Nonferrous Metals (GRINM) in 1952 and the Baotou Research Institute of Rare Earths in 1963 (BRIRE). The sector could not progress beyond the mining phase of the supply chain until engineers developed an indigenous REE separation capability at

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<sup>184</sup> Cindy A. Hurst, "China's Rare Earth Industry: What Can the West Learn?" Institute for the Analysis of Global Security (IAGS), March (2010): 1–41.

<sup>185</sup> Levkowitz, "China's Rare Earths Industry and its Role in the International Market," 2–3.

<sup>186</sup> Tse Pui-Kwan, "China's rare-earth industry," U.S. Geological Survey Open-File Report 1042 (2011): 1–11. Accessed at <http://pubs.usgs.gov/of/2011/1042>.



BRIRE in the 1970s. In that case, a Columbia-trained nuclear chemist, Xu Guangxian, successfully applied his research in uranium isotope extraction to rare earth extraction.<sup>187</sup>

Production took off during the first phase of reforms (1979-1992), as industrial policies stimulated the domestic mining sector. During this period, productivity grew from 1,000 tons in 1978 to 11,860 tons in 1986.<sup>188</sup> That same year, the Bayan Obo mine surpassed its primary global competitor, the U.S.-owned Mountain Pass mine in California.<sup>189</sup> In the second phase of reform (since 1992), the sector acquired strategic significance and REEs became a protected strategic mineral. Though probably attributable to industrial mythology, Deng Xiaoping supposedly visited the Bayan Obo mine in 1992 as part of his famous Southern Tour and declared: “The Middle East has oil, and China has rare earths.”<sup>190</sup> That year, China’s Ministry of Land Reform (MLR) prohibited foreign companies from mining or smelting REEs on Chinese soil unless they became joint ventures with Chinese enterprises.<sup>191</sup> A decade later in 2002, China’s National Development Reform Commission (NDRC) issued temporary guidelines: 1) forbidding foreign companies from mining REEs in China; 2) encouraging foreign and joint ventures to invest in value-added REE production.<sup>192</sup>

As Chinese exports permeated the global market in the 1990s, the previously dominant U.S. REE industry collapsed due to falling prices and the domestic costs of environmental regulatory compliance. The U.S. REE mining industry limped along until 2002 when the sole-sourced Mountain Pass mine located in California shut down.<sup>193</sup> From then on, the United States became a net REE importer, joining Japan, South Korea, Germany and France. With a near global monopoly, Chinese production soared, and

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<sup>187</sup> Hurst, “China’s Rare Earth Industry: What Can the West Learn?” 8.

<sup>188</sup> For a detailed description of these macroeconomic policies see Chapter 16 in Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge: MIT Press, 2007): 377–400.

<sup>189</sup> Jianjan Tu, “An Economic Assessment of China’s Rare Earth Policy,” The Jamestown Foundation, China Brief 10:22 (2010): 2–5.

<sup>190</sup> *Ibid.*, 3.

<sup>191</sup> Tse, “China’s rare-earth industry.”

<sup>192</sup> U.S. Library of Congress, Congressional Research Service, *China’s Rare Earth Industry and Export Regime: Economic and Trade Implications for the United States*, by Wayne M. Morrison and Rachel Tang, CRS Report R42510 (Washington, DC: Office of Congressional Information and Publishing, April 30, 2012), 18.

<sup>193</sup> Levkowitz, “China’s Rare Earths Industry and its Role in the International Market,” 2.

reached approximately 130,000 tons of REEs in 2010. Global demand was approximately 134,000 tons, of which China's domestic demand was nearly 60%.<sup>194</sup> Just as rising energy demands transformed China to a net oil importer in the mid 1990s, experts predict domestic REE demand could overtake domestic production in the short term.<sup>195</sup> In other words, like its global importers, China is increasingly dependent on its REE sector to meet rising domestic demands, undermining the long-term viability of REEs as a coercive lever.

Steady growth of Chinese REE demand reflects four underlying trends. First, China uses massive quantities of light REEs as catalysts in heavy chemical and steel industries, which remain strategic sectors in the Chinese economy. Second, Beijing's industrial policies created financial incentives for foreign companies to move value-added manufacturing facilities to China. Increasingly, foreign manufacturing firms that make REE oxides, alloys and components (e.g., SmCo permanent magnets) steadily migrated there to take advantage of cheap labor and relatively lax environmental standards. Several are Japanese-owned, which began leaving Japan over the 1980s and 1990s due to falling REE prices and environmental concerns.<sup>196</sup> This trend accelerated following China's 2001 WTO accession and the apparent business confidence this achievement inspired in the Chinese market climate. These policies support domestic movement up the REE value-added supply chain.

Third, and relatedly, Beijing's REE export regime employed export quotas and value added taxes to shape REE prices and enhance domestic financial incentives.<sup>197</sup> The Ministry of Commerce (MOFCOM) issues quotas to 31 authorized REE exporters, who may trade quotas as commodities, effectively selling the right to export REEs by the

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<sup>194</sup> Tu, "An Economic Assessment of China's Rare Earth Policy," 2–5.

<sup>195</sup> U.S. Library of Congress, Congressional Research Service, *Rare Earth Elements: The Global Supply Chain*, by Marc Humphries, CRS Report R41347 (Washington, DC: Office of Congressional Information and Publishing, September 6, 2011).

<sup>196</sup> Keith Bradsher, "Taking a Risk for Rare Earths," *The New York Times*, Mar 8, 2011, B1.

<sup>197</sup> Keith Bradsher, "U.S. Called Vulnerable to Rare Earth Shortages," *The New York Times*, Dec 15, 2010, B1.

ton.<sup>198</sup> Between 2005 and 2011, China reduced export quotas by 54% from a high of 65,000 tons to 30,300 tons. It kept the same quota in 2012.<sup>199</sup> Though raising concern among foreign REE importers, these industrial policies contributed to a global REE price boom over the same time period. Interestingly, this boom enhanced the business case for foreign companies to invest in REE reserve exploration outside China.<sup>200</sup> Contrary to the expectation of massive profits due to state intervention, Chinese enterprises have not benefitted from rising international market prices. As Yufan Hao and Weihua Liu note, “the export price of neodymium oxide is only about \$200,000 per ton, whereas the re-export price of the purified neodymium produced by foreign companies is as high as \$200,000 per kg.”<sup>201</sup>

Fourth, China’s domestic REE enterprises are maturing after more than 60 years of experience and intellectual capital invested in the industry, a significant development given the role of REE-based components in dual-use and green technologies. In contrast with the low value-added characteristic of Chinese advanced electronics assembly, the Chinese REE sector may represent an indigenous industry in which China could eventually tilt the R&D balance in its favor.<sup>202</sup> The sector gradually climbed the supply chain from mining, separation and refining to alloying and manufacturing components. Though China still lags behind the United States and Japan in the latter, the gap narrowed in 1995 when China purchased a U.S.-owned samarium cobalt (SmCo) permanent magnet company called Magnaquench and shifted all production to China by 2002.<sup>203</sup>

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<sup>198</sup> Keith Bradsher, “China Is Said to Resume Shipping Rare Earth Minerals,” *The New York Times*, October 29, 2010, B1.

<sup>199</sup> *Xinhua*, “China to keep rare earth quotas unchanged for 2012,” December 28, 2011. Accessed at: [http://news.xinhuanet.com/english/video/2011-12/28/c\\_131331565.htm](http://news.xinhuanet.com/english/video/2011-12/28/c_131331565.htm)

<sup>200</sup> Levkowitz, “China’s Rare Earths Industry and its Role in the International Market,” 4.

<sup>201</sup> Yufan Hao and Weihua Liu, “Rare Earth Minerals and Commodity Resource Nationalism,” in Mikal E. Herberg, ed. *Asia’s Rising Energy and Resource Nationalism Implications for the United States, China, and the Asia-Pacific Region* NBR Special Report 31 September (2011): 39–52.

<sup>202</sup> Greg Linden et al., “Who Captures Value in a Global Innovation System? The Case of Apple’s iPod,” University of California, Irvine, Personal Computing Industry Center, June (2007): 2–10.

<sup>203</sup> Hurst, “China’s Rare Earth Industry: What Can the West Learn?” 12–13.

Since then, China became the leading supplier of permanent magnets, which make computers smaller, spin modern windmills and shift the fins on laser guided bombs.<sup>204</sup>

In sum, by dominating the global REE industry China steadily acquired more knowledge over time than the competition. This accumulation facilitated the domestic sector's vertical movement up the value-added supply chain from REE mining to REE-derived component manufacture.<sup>205</sup> In addition to GRINM and BRIRE, there are two state-run laboratories: the Rare Earth Materials Chemistry and Applications lab affiliated with Peking University and the Rare Earth Research Utilization lab affiliated with the Chinese Academy of Sciences. The Chinese Society of Rare Earths publishes the only REE dedicated journals globally.<sup>206</sup> An informed reader perusing volume 29, issue one of the 2011 *Journal of Rare Earths*, would find esoteric titles like, "Synthesis, crystal structures and characterization of a pair of TbIII-based enantiomers." Though foreign scientists consume this information, Chinese scientists research much of the content.

Despite the strengths of Chinese REE industry, it faces many of the same development challenges discussed earlier in this chapter (e.g., growth at any cost). As with other sectors, these challenges undermine central efforts to consolidate the REE industry in ways aligned with broader economic development goals. In the context of economic statecraft, these challenges also raise the transaction costs associated with coercive exercise of the REE lever. The next sections specify development challenges in the REE industry and Beijing's efforts to rein them in.

### **3. Why China's Grip on the REE Industry is not a Sure Thing**

The REE industry faces several development challenges that undermine Chinese dominance from overcapacity and environmental degradation to illegal mining and

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<sup>204</sup> U.S. Library of Congress, Congressional Research Service, *Rare Earth Elements: The Global Supply Chain*, by Marc Humphries, CRS Report R41347 (Washington, DC: Office of Congressional Information and Publishing, September 6, 2011).

<sup>205</sup> Richard Stone, "As China's Rare Earth R&D Becomes Ever More Rarefied, Others Tremble," *Science* 325: 5946 (2009): 1336–1337.

<sup>206</sup> Hurst, "China's Rare Earth Industry: What Can the West Learn?" 9.

smuggling.<sup>207</sup> Overcapacity prevents Beijing from controlling its reserves and ensuring domestic demands are met. Multiple environmental impacts undermine sustainable growth, both in terms of rehabilitation and regulatory compliance costs. Many smaller enterprises are inefficient, ill equipped and marginally profitable (~1–5%). Illegal mining and smuggling operations further siphon REE profits away from China's balance sheet to black markets. As with energy demand, China's domestic REE demand continues to grow, meaning China will look increasingly abroad for REE supplies. On the one hand, these outcomes undermine the assumption of state-control over the REE sector, potentially constraining Beijing's exercise of the REE lever. On the other hand, Beijing launched multiple regulatory and consolidation initiatives to address the above challenges. It is unlikely development of economic statecraft capabilities motivated Beijing's recentralization efforts.

Most of these challenges arose in the context of devolving central-local relations during the second phase of reform. Known as “growth at any cost,” central policies encouraged local officials to promote local commercial sectors, provided they could sustain a high growth rate. Given considerable latitude to implement central guidance, local officials overlooked environmental, safety and licensing regulations, “to avoid facing the dangers from job losses and decreased revenue, including social unrest, destabilization and possible demotion.”<sup>208</sup> In the REE sector, deregulation of the mining industry allowed scores of “small scale and technologically backward mines and separation plants” to acquire REE licenses easily. This overcapacity stemmed from a 1981 central policy, called Let Water Flow Rapidly, “to stimulate no holds-barred mining developments to meet a rapid spike in resource demand without appropriate considerations of environmental protection, safety and sector consolidation.”<sup>209</sup> A 1985 export tax rebate accelerated the number of new REE mining enterprises, often equipped

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<sup>207</sup> Tu, “An Economic Assessment of China's Rare Earth Policy.”

<sup>208</sup> Bergsten et al., “Center-Local Relations: Hu's in Charge Here?”

<sup>209</sup> Tu, “An Economic Assessment of China's Rare Earth Policy,” 3; Hurst, “China's Rare Earth Industry: What Can the West Learn?” 20–23.

with archaic technology.<sup>210</sup> As a result, Beijing did not exercise much control over the sector's production capacity or regulatory compliance.

Persistent environmental and public health risks plague the Chinese REE sector, raising the prospects for social unrest in the surrounding populations. Because REE refinement requires copious amounts of chemical solvents, production of every ton of REEs generates approximately 29 pounds of dust, 420,000 cubic feet of gas, 2600 cubic feet of wastewater, and one ton of radioactive waste. Wastewater routinely seeps into rivers and streams, while poor air quality afflicts many REE mining towns. The townspeople drink contaminated water and breathe carcinogenic air. In 2009 there were 5,387 cases of black lung in Baotao alone.<sup>211</sup> Despite difficulty enforcing regulations at the local level, Beijing cannot afford to ignore the social risks of environmental damage.<sup>212</sup>

None of the above environmental risks is unique to China. As REE facilities shutdown worldwide due to environmental and regulatory costs, China's REE sector expanded in the context of "growth at any cost." On the one hand, lax regulations allowed Chinese REE companies to produce at approximately one third the cost of foreign competitors.<sup>213</sup> On the other hand, foreign companies benefitted from access to cheap REEs from China, alleviating the need to invest in REE mining and exploration. In this respect, industrial critiques of China's dominance are somewhat dubious: other REE reserves exist, but further exploration and extraction have not been profitable given high transaction costs. In an interview with Lluís Fontboté, economic geologist at the University of Geneva, the trade publication *Earth* noted, "many published estimates of world mineral reserves actually reflect fluctuations in the market for a mineral, and thus in a country's or company's eagerness to invest in exploration for that mineral, rather than geological realities."<sup>214</sup>

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<sup>210</sup> Hao and Liu, "Rare Earth Minerals and Commodity Resource Nationalism," 43.

<sup>211</sup> Hurst, "China's Rare Earth Industry: What Can the West Learn?" 16–18.

<sup>212</sup> Elizabeth C. Economy, "The Great Leap Backward?" *Foreign Affairs* 86:5 (2007).

<sup>213</sup> Hurst, "China's Rare Earth Industry: What Can the West Learn?" 17.

<sup>214</sup> Carolyn Gramling, "Is there really a minerals crisis?" *Earth: The Science Behind the Headlines* July 8, 2011.

In addition to supply-side efforts to influence global REE prices, illegal mining and smuggling operations in Southern China are major drivers of government efforts to control exports. While the Bayan Obo mine sits on more than 80% of China's REEs, most are the more common light variety. In contrast, nearly all 1.5 million tons of known heavy REEs (~2.7%) reside in Southern China where operations run by crime syndicates reduced China's mineable resources and drove prices down through cutthroat competition. The problem is clearly evident in Guangdong province, in which official production in 2008 was 2,553 tons, compared with an actual output estimated at between 25–30k tons.<sup>215</sup> In other words, only 10% of Guangdong's REE exports made it to China's balance sheet.

#### **4. Polluters, Illegal Miners and Smugglers Need Not Apply**

Consistent with broader recentralization initiatives, Beijing issued new guidance in the late 2000s to rein in regulatory control from local officials. The main thrust involved consolidating larger operations and cracking down against illegal mines. A 2008 restructuring plan outlined consolidation of all 100 REE enterprises into 20 companies organized under three regional districts by 2015. These were the northern district (Inner Mongolia and Shandong), the western district (Sichuan) and the southern district (Jiangxi, Guangdong, Fujian, Hunan and Guangxi). Meanwhile, Beijing's leading agency over REEs, the Ministry of Industry and Information Technology (MIIT), would conduct planned and spot inspections to ensure regulatory compliance. In 2008, state-owned Baotao Steel created the Inner Mongolia Baotao Steel Rare Earth High-Tech Co. as the national REE commercial hub.<sup>216</sup> Following Japan's lead, which began stockpiling decades ago, the Ministry of Land and Resources (MLR) recently ordered Inner Mongolia Baotao Steel Rare Earth (Group) to build ten REE storage facilities.<sup>217</sup>

In the southern provinces, consolidation and regulatory measures specifically targeted illegal REE operations, overcapacity and ineffective local governance. Again,

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<sup>215</sup> Tu, "An Economic Assessment of China's Rare Earth Policy."

<sup>216</sup> Hurst, "China's Rare Earth Industry: What Can the West Learn?" 23–23.

<sup>217</sup> James T. Areddy, "Tightening Its Grip, China Begins To Stockpile Rare-Earth Metals," *The Wall Street Journal*, February 7, 2011.

this region matters since it contains the vast majority of medium and heavy REE reserves. Reorganization in Jiangxi began in 2008 with the establishment of the China Minmetals Rare Earth Co., headquartered in Ganzhou City. In 2009, MLR attempted to regain control of limited heavy REE resources by suspending issuance of mining and survey licenses.<sup>218</sup> In 2011, MLR took direct control over 11 REE mining districts in Jiangxi, stripping administrative oversight from the provincial and local level.<sup>219</sup> Guangdong Rising Nonferrous Metals Group Co, became the only legal mining company in Guangdong province.<sup>220</sup> Central sponsored SOEs have met local resistance. For example, state-owned companies such as China Minmetals Corp. and Aluminum Corporation of China (Chinalco) pushed to enter the Jiangxi Province market (rich in heavy rare earth deposits, especially in Ganzhou), but found that the local Ganzhou Rare Earth Minerals Industry Co. Ltd. had a monopoly over licensing.<sup>221</sup>

New environmental standards emerged in 2009 with the Ministry of Environmental Protection's (MEP) issuance of the Rare Earth Pollutant Discharge Standards. This initiative established standards for six types of airborne and 14 types of waterborne pollutants. Given that regulatory compliance could cost an additional 145 to 220 dollars per ton of REE produced, Chinese companies will have difficulty absorbing the required overhead without assistance from Beijing.<sup>222</sup> Since no such environmental regulations existed for the REE sector previously, REE operators were not technically guilty of noncompliance. This clean slate ended when implementation took effect in 2011. In November that year, MEP announced the results of its first environmental compliance inspections of 84 REE companies in 14 provinces, noting that submission of

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<sup>218</sup> Hurst, "China's Rare Earth Industry: What Can the West Learn?" 23.

<sup>219</sup> Keith Bradsher, "China Seizes Rare Earth Mine Areas," *The New York Times*, January 20, 2011.

<sup>220</sup> Zhanheng Chen, "Outline on the Development and Policies of China Rare Earth Industry," The Chinese Society of Rare Earths (CSRE).

<sup>221</sup> U.S. Library of Congress, Congressional Research Service, *China's Rare Earth Industry and Export Regime: Economic and Trade Implications for the United States*, by Wayne M. Morrison and Rachel Tang, CRS Report R42510 (Washington, DC: Office of Congressional Information and Publishing, April 30, 2012).

<sup>222</sup> Hurst. 24.



environmental impact assessment reports was a prerequisite for legal mining operations.<sup>223</sup>

## F. CONCLUSION

Scholarly analysis of China's REE industry and the 2010 embargo is relatively scarce. In one of the few academic sources to treat China's REE sector, Robert Looney tentatively concludes China's global REE dominance may reflect a policy shift away from market-driven growth to technocratic retrenchment, which he dubs "a new technocratic mercantilism."<sup>224</sup> Approaching the sector from an energy security perspective, Mikal Herberg cautions Chinese REE dominance exacerbates East Asian "import dependence for critical energy and industrial inputs."<sup>225</sup> More recently, in a National Bureau of Asian Research study edited by Herberg, Yufan Hao and Weihua Liu argue that misperception informs foreign observations of China's REE industry. Apparently protectionist policies are driven primarily by domestic politics, rather than an interest in global domination.<sup>226</sup> Jane Nakano argues that regardless of Chinese intentions, the 2010 REE suspension, "dealt a detrimental blow to Japanese perceptions of China as a reliable economic partner."<sup>227</sup>

In sum, this study did not find sufficient evidence indicating Beijing developed the REE sector specifically for coercive exercise in economic statecraft. Instead, Beijing promoted the sector to support economic development priorities based on the prominent role of REEs in heavy industries and advanced technologies. Certainly Beijing sought the technological value of REEs. To these ends, Beijing pursued industrial policies that set prices and lured foreign companies to China to acquire best practices and technology. Though this state intervention was arguably protectionist, enhancing domestic

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<sup>223</sup>Xinhua, "China's environmental watchdog tightens control over rare earth projects," November 24, 2011.

<sup>224</sup> Robert Looney "Recent Developments of a New Technocratic Mercantilism Emerging in China?" *World Economics* 12:1 (2011), 71.

<sup>225</sup> Herberg, "The Rise of Energy and Resource Nationalism in Asia," 138–139.

<sup>226</sup> Hao and Liu, "Rare Earth Minerals and Commodity Resource Nationalism."

<sup>227</sup> Jane Nakano, "Rare Earth Trade Challenges and Sino-Japanese Relations: A Rise of Resource Nationalism?" in Mikal E. Herberg, ed. *Asia's Rising Energy and Resource Nationalism Implications for the United States, China, and the Asia-Pacific Region* NBR Special Report 31 September (2011): 53–66.

productivity and global competitiveness were the goals. Beijing's strategic minerals designation, export regime and prohibition against foreign companies from REE mining certainly fomented suspicions of mercantilism. Conscious of its WTO obligations, Beijing asserts its export restrictions are within compliance and that industrial regulations apply to the domestic sector as well. Of course, these measures are documented in a WTO complaint filed by the United States, the EU and Japan in March 2012.<sup>228</sup> Though wary of protectionism, foreign REE companies continue to move to China to take advantage of incentives and increased REE profits. Meanwhile, rising REE prices hastened the business case for a resurgence in global REE exploration, benefitting the industry in the long term.

Perhaps new environmental regulations cover Beijing's mercantilist retrenchment. More likely this trend reflects broader recentralization efforts to manage the deleterious effects of "growth at any cost." Though in recent years Beijing made great strides in environmental regulatory policy, lax enforcement at the local level remains a challenge.<sup>229</sup> Here, Beijing cannot ignore the environmental costs of unregulated REE activities without risking unacceptable levels of social unrest, and therefore, regime survivability.<sup>230</sup> Though the temptation to project an intentional 60-year coercive lever development strategy on Beijing may be an appealing prospect, this study cannot make that claim. Recognition of the value of REEs as a potential coercive lever probably occurred over the past decade as movement of Japanese REE companies to China accelerated in the wake of WTO accession. This movement deepened conditions of asymmetric interdependence in the REE sector and ultimately provided Beijing with a coercive lever. The lever remained latent until 2010 when a bilateral dispute escalated into an international crisis. Only then did Beijing decide to exercise it coercively to advance policy objectives against Tokyo.

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<sup>228</sup> See the China member page on the WTO website, accessed at:  
[http://www.wto.org/english/thewto\\_e/countries\\_e/china\\_e.htm](http://www.wto.org/english/thewto_e/countries_e/china_e.htm)

<sup>229</sup> Elizabeth C. Economy, "The Great Leap Backward?" *Foreign Affairs* 86:5 (2007).

<sup>230</sup> Shirk, *China: Fragile Superpower*, 60.

## IV. REE EMBARGOS MAKE WAVES IN THE EAST CHINA SEA

### A. INTRODUCTION

This case study involves Beijing's suspension of rare earth element (REE) shipments to Japan in response to a 2010 maritime crisis in disputed waters near the Senkakus Islands in the East China Sea.<sup>231</sup> This study argues Beijing's imposition of the two-month REE embargo was an example of explicit coercive lever exercise, that in concert with diplomatic and propaganda campaigns, achieved short-term political objectives. Given Beijing's preference for inducements outlined in the previous chapter, the immediate question is why did Beijing shift to coercion in this case? How did it exercise the lever? What did it hope to achieve? If this study adopted Paul Krugman's explanation from the opening vignette in chapter I, then there would be little reason for this case study. Beijing simply revealed its true colors; the market-oriented reforms of the past thirty years were a sham.

Yet, there can be little doubt that coercive lever exercise conflicted with Beijing's efforts to promote China as a responsible major power abroad. As discussed in the previous chapter, reputation management is a core element of Chinese grand strategy in which economic statecraft plays an increasingly important supporting role. At the same time, as with other examples of Chinese foreign policy behavior, coercive lever exercise is subject to diverse interpretations. The obvious contrast is the example of Beijing's participation in multi-lateral sanctions against North Korea raised in chapter I. In that case, coercive exercise was associated with upholding status quo norms, and therefore, lauded by the international community. Here again, some observers would like to see less Chinese economic statecraft; others would like to see more.

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<sup>231</sup> Examples of international media, trade press, think tank, academic and U.S. government sources for the Sino-Japan case are: Keith Bradsher, "China is Blocking Minerals, Executives Say," *The New York Times*, September 24, 2010; R. Colin Johnson, "Rare Earths Get Rarer," *Electronic Engineering Times*, August 15, 2011; Cindy A. Hurst, "China's Rare Earth Industry: What Can the West Learn?" Washington D.C., Institute for the Analysis of Global Security (IAGS), March 2010; Robert Looney, "Recent Developments of a New Technocratic Mercantilism Emerging in China?" *World Economics* 12:1 (2011).

While the episode could mark a shift in Beijing's preferences towards more frequent coercive lever exercise, the more plausible explanation is that this was a rare case under extreme conditions in which coercive lever exercise became a viable policy option. This explanation is consistent with H1 predictions. If correct, there are two corollaries. First, exercise of the lever demonstrated a rising level of sophistication in Chinese economic statecraft. As predicted by H2, Beijing cannot yet pursue coercive lever exercise in support of long-term policy objectives particularly when exercise conflicts with strategic or economic development priorities. Short-term objectives are within its grasp. Second, Beijing demonstrated an unprecedented willingness to link coercive lever exercise across economic and security objectives during an international crisis. It is reasonable to expect that under similar circumstances, Beijing could exercise coercive levers again as a policy option. This outcome merits monitoring the indications of Beijing's coercive lever exercise future international crises.

Coercive lever exercise followed the process of stages outlined in chapter II: asymmetric, situational, application and effects. First, China and Japan are near peer economic competitors; conventional Hirschmanesque logic does not apply to Sino-Japanese relations. While China surpassed Japan as the second largest economy in 2010, trade relations remain relatively balanced, and Japan's per capita GDP is much larger. Because Japan depends exclusively on China for REE imports, while China can diversify its exports, asymmetric interdependence exists in the REE sector. This sectorial asymmetry was sufficient for Beijing to exercise the REE embargo as a coercive lever. Beijing's imposition of the REE embargo was not part of a trade war in response to a similar action by Tokyo. Its trigger was not economic. Instead, the embargo arose in the context of an ongoing bilateral security dispute.

Consistent with research by Papayouanou, Kastner, Kahler, Drezner, Segal and Shirk, this study argues the escalatory nature of the 2010 flare-up in the Senkakus dispute emboldened Beijing to make two key decisions in the situational stage: 1) it could assume the risk of coercive lever exercise as a viable policy option, 2) it could pursue short-term political objectives with limited expectations of success. Additionally, three factors informing Beijing's calculus were the persistence of "cold politics, hot economics" in

Sino-Japanese relations, anti-Japanese nationalism in China, and heightened perceptions of the China threat in Japan. Here, Beijing's expectation of future conflict with Japan as a non-allied target state certainly met the criteria of Drezner's sanctions paradox. Interestingly, Beijing was more successful than Drezner might predict. Meanwhile, on the Japanese side, Papayouanou, Kahler and Kastner's warnings over the need to stay abreast of shifts in the domestic political balance within China proved significantly resonant in this case.

The way the crisis unfolded in the situational stage also shaped transaction costs among policy options, affecting Beijing's decision to exercise the REE lever coercively. Compared with past flare-ups in the Senkakus Islands and East China Sea, the 2010 Senkakus dispute escalated rapidly and pressurized Beijing's crisis response apparatus. In this flare-up, Beijing confronted the convergence of what Shirk might have called a perfect nationalist storm. Nationalism added a sense of urgency and conflict that exacerbated tensions among foreign policy stakeholders. Hardliners probably pushed for coercive measures that would signify Beijing's protest and resolve. Drawing on Ross and Segal, since the balance of military power still favored Japan and its ally the United States, Beijing's coercive options were scarce. Coercive lever exercise arose as a feasible escalatory tactic that fell short of military force. As this case study will show, Beijing pursued several coercive policies simultaneously, in which coercive lever exercise played an integral role.

Interaction between grand strategy, foreign policy making and political economy trends shaped events in the application stage. Coercive exercise was a clear departure from Beijing's preference for inducements in economic statecraft. Because the pro-growth coalition remained concerned with China's international reputation as a economic partner, Beijing did not exercise the lever officially or for a prolonged period of time. It is also possible the pro-growth coalition grew concerned prolonged exercise could impact development priorities. Though dubious, this approach offered a modicum of plausible deniability to China's top leaders in the context of its WTO accession protocol. From the center, Beijing exercised the lever by imposing uniform export restrictions on all 31 authorized REE exporters in China. At the provincial level, customs officials prevented

ships loaded with REE exports bound for Japan from leaving the pier, but allowed ships to get underway for other destinations. Tactics included increased customs clearance inspections on air and ship cargo. Though Beijing repeatedly denied ordering the ban at all levels, exercise was explicit based on Japanese industry and government reports that showed marginal levels of Chinese REE exports to Japan during the two-month embargo.

By exercising the REE coercive lever, Beijing sought three short-term political objectives that targeted Tokyo and the Japanese REE industry. First, signaling resolve and amplifying Beijing's official protest against Tokyo in the context of ongoing territorial and maritime disputes. Second, contributing to release of the Chinese captain, effectively ending the crisis. Third, coercive lever exercise also targeted the Japanese REE industry to commence a third wave of migration. In contrast with past efforts to lure REE business through market-oriented incentives, Beijing opted for coercion in this case. It sent a clear signal to Japanese companies that China could disrupt unrefined REE supplies, hastening relocation of some Japanese-owned REE manufacturers to China. For China's domestic REE industry, exercise supported vertical integration of the value-added supply chain. Wary of the disruptive effects of prolonged exercise on development priorities, Beijing viewed coercive exercise as a temporary tactic.

Effects of the REE embargo continue to unfold. China made little headway toward resolving its bilateral disputes with Japan in the Senkakus and East China Sea, though this outcome matched Beijing's short-term objectives. Instead, Beijing's three-pronged response to the crisis exacerbated nationalist sentiments on both sides, pushed Japan closer to the U.S.-Japan security alliance and raised Japanese perceptions of the China threat. Multinational state and commercial efforts commenced to diversify global rare earth sources. More than 18 months after the episode, the United States, Japan and the European Union (EU) filed a WTO complaint against Chinese REE export restrictions in March 2012, undermining China's compliance with its 2001 accession protocol. This chapter discusses key events during the crisis timeline and briefly covers the Sino-Japanese disputes in the Senkakus and East China Sea. Next, it examines how China applied the coercive lever mechanism in greater detail. Finally, this chapter concludes with sections on commercial and state responses to the REE embargo.

## **B. A THREE-PRONGED RESPONSE TO DETENTION OF CAPTAIN ZHAN**

### **1. Background**

Though punctuated by a status quo of “cold politics, hot economics,”<sup>232</sup> Sino-Japanese relations deteriorated in September 2010 following a maritime crash near the Senkaku island chain in the East China Sea, where both sides have unresolved territorial and maritime claims. On September 7, a Chinese fishing vessel underway in Japan’s claimed Exclusive Economic Zone (EEZ) collided with two Japanese Coast Guard ships near one of the Senkaku Islands, which Japan has administered since 1972.<sup>233</sup> Tokyo broke with the established pattern of escorting unauthorized vessels outside of its EEZ and deporting their crews. Instead, it detained the fishing vessel’s Chinese crew, including its captain, and commenced legal procedures under Japanese domestic law. This deviation from the status quo escalated the crisis to another level. It confounded Beijing and intensified nationalist pressures on both sides, creating ideal conditions for coercive lever exercise.

Given the likelihood of future conflict in Sino-Japanese relations, China’s official response was swift, persistent, and resolute. On September 8, Beijing issued a protest demanding the crew’s release with Ambassador Niwa Uchiro, who was just shy of his second month as Japanese ambassador to China. The next day, Beijing sent a Fishery Administration vessel to patrol the disputed area, reportedly to protect its fishermen. Midnight September 11, Chinese State Councilor Dai Bingguo demarched Ambassador Niwa yet again. In response to ramped-up pressure, Japan released the 14-member crew

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<sup>232</sup> Despite normalization in 1972, Sino-Japanese relations remain challenged by persistent mistrust and historical issues lingering since WWII. See for example, Shirk, *China: Fragile Superpower*, 140–180; Ian Buruma, *The Wages of Guilt: Memories of War in Germany and Japan* (New York: Farrar Straus Giroux, 1994); Thomas U. Berger, “The Politics of Memory in Japanese Foreign Relations,” in *Japan’s International Politics: The Foreign Policies of an Adaptive State*, ed. Berger, Mike M. Mochizuki, and Jitsuo Tsuchiyama (Boulder, Colo.: Lynne Rienner, 2007), 179–211.

<sup>233</sup> The islands are actually owned privately and administered through a lease, which prevents Tokyo from stationing Self Defense Forces on them. See James J. Przystup, “Japan-China Relations: Troubled Waters: Part II,” *Comparative Connections* January (2011).

and vessel on September 13, but in an unusual move, it kept Captain Zhan Qixiong in detention on Okinawa.<sup>234</sup>

Coercive lever exercise arose as a component of China's three-pronged response to the crisis, initially dominated by aggressive diplomatic and information campaigns. By mid-September, the diplomatic lines were essentially fixed. China argued Japan detained the crew and ship illegally, and called for the immediate release of Captain Zhan. Japan argued the vessel's fishing activities were illegal in Japanese waters, and that the ship obstructed Japanese authorities by ramming the Coast Guard ships. As such, the Ishigaki court on Okinawa would decide the matter. China's propaganda apparatus amplified diplomatic pressure through state-run and commercial media outlets. For example, a *China Daily* article linked the deteriorating health of Captain Zhan's family members with his continued detention by Japanese authorities.<sup>235</sup> Beijing applied the same tactic during the 2001 U.S. EP-3 collision with a Chinese F-8 near Hainan Island.

Over the next two weeks, China suspended diplomatic exchanges, allowed small-scale anti-Japan protests and arrested four Japanese construction workers in Hebei province, located in northern China. On September 20, the Ishigaki court on Okinawa extended Captain Zhan's detention until at least September 29. The next day, Beijing announced Premier Wen would not meet with Prime Minister Kan at the United Nations General Assembly in New York scheduled that week, though Japanese Chief Cabinet Secretary Sengoku had already made similar comments. In fact, during an event in New York, Prime Minister Wen warned, "if Japan clings to its course, China will take further action."<sup>236</sup> Though a Hu-Wen meeting did not occur at UNGA, on September 23 Foreign Minister Maehara did meet with Secretary of State Clinton, who reaffirmed the U.S.-Japan security alliance applied to the Senkakus.<sup>237</sup> U.S. Secretary of Defense Robert Gates and Chairman of the Joint Chiefs of Staff Admiral Mike Mullen made the

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<sup>234</sup> James J. Przystup, "Japan-China Relations: Troubled Waters" *Comparative Connections* October (2010).

<sup>235</sup> See for example, Wei Tian, "Arrest Brings Calamity to Trawler Captain's Family," *China Daily*, September 13, 2010. Accessed at: [http://www.chinadaily.com.cn/china/201009/13/content\\_11290837.htm](http://www.chinadaily.com.cn/china/201009/13/content_11290837.htm)

<sup>236</sup> Ian Johnson, "China Takes a Sharper Tone in Dispute With Japan," *The New York Times*, September 22, 2010.

<sup>237</sup> James J. Przystup, "Japan-China Relations: Troubled Waters."



same affirmation at a press conference. As these responses played out publicly, coercive lever exercise evolved on the margins.

Both the diplomatic and information campaigns were clearly coercive. Short of military intervention, negative transaction costs were largely sunk costs. From an economic statecraft perspective, making the shift from inducements to coercion was not much of a leap under the circumstances. Indications of coercive lever exercise emerged on or about September 23, when Japanese industry executives alleged that Chinese customs officials were halting outbound REE shipments to Japan. Ships loaded with REE containers remained tied to the pier. This widely reported event appeared to alter the calculus in Tokyo. At the same time, U.S. reassurances at UNGA presumably influenced Japan to expedite resolution to the crisis.<sup>238</sup> Initially vowing to prosecute the captain in the Ishigaki court on Okinawa, Tokyo backed down instead. Subsequent release of the Chinese captain on September 24 did not ease tensions immediately. Beijing demanded an apology, and rejecting that, Tokyo demanded compensation for damages to its Coast Guard ships.<sup>239</sup> Meanwhile in Japan, Prime Minister Kan's approval rating dropped 10% and Japanese headlines proclaimed "diplomatic defeat."<sup>240</sup>

The captain's release did not end REE suspension either. As the first week of the embargo continued, mixed reports from industry sources indicated a spike in customs clearance inspections in several Chinese provinces. In Shanghai, Japanese trading houses reported imposition of 100% "sample inspection" rates of outbound REE shipments by Chinese customs agencies. Air cargo "quarantine inspections" of electronics with REE components also increased from 10%–50%. Reports cited similar activity in Fujian, Guangdong and Liaoning Provinces.<sup>241</sup> China produces roughly 95% of the global supply of REE exports and Japan depends on China for roughly 85% of its REE imports. In an interview with *The Japan Times*, a Japanese REE importer, Kanmaterial Corp.

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<sup>238</sup> Michael J. Green and Nicholas Szechenyl, "US-Japan Relations: Hitting the Reset Button," *Comparative Connections* October (2010).

<sup>239</sup> Michael D. Swaine and M. Taylor Fravel, "China's Assertive Behavior Part Two The Maritime Periphery," *China Leadership Monitor* 35 (2011): 1–29. 8.

<sup>240</sup> Green and Szechenyl. "US-Japan Relations: Hitting the Reset Button."

<sup>241</sup> *The Yomiuri Shimbun*, "China Toughens Customs Clearance," September 26, 2010.

Chairman Katsuyuki Matsuo, summed up this asymmetry succinctly, "it is no exaggeration to say that Japan is the only country inconvenienced by restrictions on Chinese exports of rare earths."<sup>242</sup> A September 29 *Yomiuri Shimbun* editorial cited the REE embargo as a call to reverse the course of manufacturing to China over the past decade: "Japanese companies should take this opportunity to reconsider their business strategy of concentrating production centers and investment in China, and instead start exploring new markets as the first step to reducing business risks."<sup>243</sup>

The crisis exacerbated nationalist sentiments on both sides. Consistent with Shirk's research on state-sponsored nationalism involving international incidents with Japan, Beijing allowed anti-Japan protests in several provinces over multiple days. Anti-Japan protests occurred in Beijing, Shanghai, Chengdu, Xian and Zhengzhou from October 16–18 and again from October 23–25. Like suspension of the 2005 anti-Japan protests after three weeks, there were limits to Beijing's acquiescence. Chinese police prevented protests from resuming during the Asian Games in Guangzhou.<sup>244</sup> Meanwhile, Japanese public opinion matched perceptions of the China threat among the business community. A *Sankei Shimbun* and *Fuji Network* spot survey found that 71.5% of Japanese respondents viewed China as a threat.<sup>245</sup> Meanwhile, a *Yomiuri Shimbun* telephone survey found that 85% of Japanese respondents did not trust China based on the way Beijing handled the crisis.<sup>246</sup>

The Chinese military was conspicuously absent throughout the crisis, suggesting Beijing was unwilling to risk a possible military confrontation with Japan, and of course, the United States. Dispatch of at least two Fishery Administration vessels in September and October did not represent a military response. Designated to patrol Chinese-claimed EEZs since 2009, Fishery Administration vessels are not part of the People's Liberation

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<sup>242</sup> Minoru Matsutani, "Japan Over a Barrel When it Comes to Rare Earth Metals," *The Japan Times*, September 30, 2010.

<sup>243</sup> *The Yomiuri Shimbun*, "Editorial: Depend on China at your Peril," September 29, 2010.

<sup>244</sup> James J. Przystup, "Japan-China Relations: Troubled Waters: Part II," *Comparative Connections* January (2011).

<sup>245</sup> *Ibid.*

<sup>246</sup> Tomohisa Tsuruta, "Public Opinion of China Slumps; After Senkaku Islands Incident, Record-High 84% Don't Trust Country," *Yomiuri Shimbun*, October 5, 2010.

Army Navy (PLAN) and ultimately report to the Fisheries Law Enforcement Command (FLEC), under the Ministry of Agriculture in Beijing.<sup>247</sup> There is little evidence PLA officials pressured their civilian counterparts to exercise the REE lever coercively, or that the military set the coercive tone of Beijing's response. Instead, PLA representatives probably fulfilled advisory and intelligence support roles as participants in formal organizations (e.g., FALSG) and in *ad hoc* crisis response groups.<sup>248</sup>

Though the REE embargo continued for nearly two months, Chinese officials at all levels repeatedly denied ordering it, including Premier Wen Jiabao. Japanese officials made little headway in negotiations.<sup>249</sup> Ministry of Economy Trade and Industry (METI) Minister Okata Akihiro urged Vice Minister of Commerce Jiang Yaping to resume REE shipments during a late October meeting in Tokyo. Initiated by the Japanese side, diplomatic relations began thawing on the margins of the East Asia Summit (EAS) in Hanoi. Separate meetings occurred between both Foreign Ministers and between Premier Wen and Prime Minister Kan on October 30. The next month, a brief Kan-Hu meeting occurred during the Asia-Pacific Economic Cooperation (APEC) summit in Yokohama on November 13. Both Foreign Minister Yang Jiechi and Premier Wen denied the embargo existed and stressed China would continue to supply REEs to Japan.

When the REE embargo did end, on or about November 20, there was no press conference in Beijing. Industry sources informed the media that shipments had resumed, unofficially ending the REE embargo the same way it began two months earlier.<sup>250</sup> The next section describes asymmetric interdependence with Japan in the REE sector that

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<sup>247</sup> Bernard D. Cole, *The Great Wall at Sea: China's Navy in the Twenty-First Century* (Annapolis, MD: Naval Institute Press, 2010), 52–53.

<sup>248</sup> Michael D. Swaine, "China's Assertive Behavior Part Four: The Role of the Military in Foreign Crises."

<sup>249</sup> Martin Fackler and Ian Johnson, "Arrest in Disputed Seas Riles China and Japan," *The New York Times*, Sept 19, 2010 (Page A1); Keith Bradsher, *The New York Times*, Sept 23, 2010; Ian Johnson, "China Arrests Four Japanese Amid Tensions," *The New York Times*, September 24, 2010, A12; Martin Fackler and Ian Johnson, "Japan Retreats With Release of Chinese Boat Captain," *The New York Times*, Sept 24, 2010, A1; Edward Wong and Keith Bradsher, "Chinese Leader Denies Using Mineral Exports for Political Ends," *The New York Times*, October 9, 2010.

<sup>250</sup> Keith Bradsher, "China Restarts Rare Earth Shipments to Japan," *The New York Times*, November 20, 2010, B5.

provided Beijing with the REE lever. As discussed in chapter III, it is unclear when precisely Beijing recognized the coercive value of this lever. It is clear, however, this asymmetry developed as a consequence of accelerated businesses migration to China in the wake of its 2001 WTO accession.

## **2. Asymmetric Interdependence Adds Injury to GDP Insult**

The 2010 Senkakus crisis played out in the context of China's much anticipated achievement as the second largest global economy. Here, China displaced Japan from a level of economic status it held since 1968, when Japan overtook West Germany.<sup>251</sup> Though technically a larger aggregate economy than Japan, measured in Gross Domestic Product (GDP) by exchange rate (e.g., 2011 GDP: China U.S. \$6.989 trillion; Japan U.S. \$5.855 trillion), the Chinese economy remains less developed relative to Japan. Because the renminbi is not convertible on China's capital account, GDP derived by the exchange rate is inaccurate. By per capita GDP, Japan remains ahead: at U.S. \$34,000, its 2011 per capita GDP was more than four-times China's at U.S. \$8,400.<sup>252</sup> Though the degree to which this reversal in global economic status matters in economic terms is debatable, it did mark a shift in international prestige from Japan to China. The key point for this study is that the two economies are near peer competitors; traditional Hirschmanesque logic does not apply since neither side depends exclusively on the other.

Asymmetric interdependence in the REE sector created the structural conditions for China to develop a coercive lever. Three additional points clarify why these conditions mattered more than aggregate economic size measured by GDP. First, China-Japan economic ties are extensive (e.g., "hot economics") and date back to the 1970s. Second, while China is Japan's primary trading partner, and a major destination for Japanese FDI, Sino-Japanese trade remains relatively balanced. In fact before the exogenous shock of the March 2011 Tsunami, Japan ran a net surplus in exports with China. Third, Japan maintains a robust domestic consumer market, insulating it from

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<sup>251</sup> David Barboza, "China Passes Japan as Second-Largest Economy," *The New York Times*, August 16, 2010, B1.

<sup>252</sup> United States Central Intelligence Agency, *The World Factbook*. Accessed at: <https://www.cia.gov/library/publications/the-world-factbook/geos/xx.html>

total reliance on export-led growth.<sup>253</sup> In sum, Japan does not depend on the Chinese economy to an extent that Hirschmanesque effects skew bilateral economic exchanges.

Japan does rely on China for between 80–90% of its REE imports primarily for its automobile and electronics industries (e.g., ~25,000 tons annually).<sup>254</sup> China is also a major destination for Japanese REE-derived exports. For example, in 2010 China exported 48% of its REEs to Japan, and it imported 82% of REE-derived products from Japan.<sup>255</sup> Given its dependence on China for both REE imports and exports, Japan cannot diversify because there are no other REE sources available globally in sufficient quantities. While Japanese companies reportedly have unknown quantities of REE stockpiles, these supplies would probably not sustain long-term operations.<sup>256</sup> Meanwhile, China does not depend on Japan as a destination for REE exports: it exports REEs to South Korea, the United States and the EU among others; and domestic demand within China could overtake production. In some respects, REE trade reflects a classic pattern of commodities for products in which China appears disadvantaged. Yet due to asymmetric interdependence in the REE sector, Japan assumed the role of a smaller economy unable to diversify its imports beyond China.

This asymmetric interdependence evolved with global industrial trends described in chapter III, notably the movement of REE mining industries to China in response to environmental concerns and global price reductions. Pushed out of Japan by these same concerns, many Japanese REE companies moved to China in two waves during the 1980s and 1990s. In the first wave, businesses relocated to China as joint ventures, lured by access to mineable REE reserves, lax environmental standards and cheap labor. Japan opened facilities elsewhere with less success. For example, work continues on Mitsubishi Chemical's \$100 million radioactive waste cleanup of its defunct REE

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<sup>253</sup> Ross, "Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia"; Eamonn Fingleton, "The Myth of Japan's Failure," *The New York Times*, January 6, 2012, SR1.

<sup>254</sup> Hiroko Tabuchi, "The Hunt for Rare Earths," *The New York Times*, November 25, 2010.

<sup>255</sup> Nakano, "Rare Earth Trade Challenges and Sino-Japanese Relations: A Rise of Resource Nationalism?"

<sup>256</sup> Hao and Liu, "Rare Earth Minerals and Commodity Resource Nationalism," 48.

refinery site in Malaysia. The site closed in 1992 after years of environmental protests by Malaysian citizens.<sup>257</sup>

In the second wave, REE-based manufacturing companies joined the flood of high technology name brand firms that set up shop in China following its 2001 WTO accession -- Mitsui Chemical, Sumitomo, NEC, Matsushita Electronics, Toshiba, Sony, Honda, Isuzu and Mazda.<sup>258</sup> This optimism began deteriorating within a few years. As discussed in chapter III, China implemented several industrial policies in the later half of the past decade to roll back unregulated growth in the REE sector. On the one hand, these policies led to price spikes that increased profits for REE exporters, including foreign firms. On the other hand, the same policies (e.g. production and export quotas) threatened business confidence for REE miners and importers.

Prior to the 2010 crisis, Japanese officials and businesses certainly understood the asymmetric effects of Chinese REE consolidation on Japan's REE industry. Due to declining Chinese export quotas from 2005 to 2009, Japanese FDI flowed to REE projects in Kazakhstan, India, Vietnam, Canada, the United States and Mongolia. Less than one month before the 2010 Senkakus crisis, METI representatives met with MOFCOM officials to discuss the 40% drop between 2009 and 2010 export quotas and the resulting 30% price spike in Japanese imports. When this level of engagement failed to increase exports, Foreign Minister Okada raised the issue with Premier Wen during the High-Level Economic Dialogue in Beijing August 28-29, who insisted the policies sought to reverse "overexploitation" and reassured Okada present export levels would continue. On September 8, the same day of the Senkakus collision, Vice Premier Li Keqiang offered the same reassurances without making concessions to Chairman Yonekura Hiromasa, leader of the *Keidanren* (Japanese Business Federation).<sup>259</sup>

Clearly by 2009, and arguably much earlier in the decade, Beijing recognized that asymmetric interdependence in the REE sector presented levers it could exercise in

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<sup>257</sup> Keith Bradsher, "Taking a Risk for Rare Earths," *The New York Times*, March 9, 2011, B1.

<sup>258</sup> James J. Przysup, "Japan-China Relations: From Precipice to promise," *Comparative Connections* 3:4 January (2002).

<sup>259</sup> Przysup, "Japan-China Relations: Troubled Waters."

economic statecraft. Japanese business activities to diversify mining sources and government communication of Japanese concerns with export restrictions implied as much. Though Beijing managed the REE export regime actively, it had not imposed an REE embargo before. It is possible the 2010 export quota reflected a deliberate preliminary step toward the embargo (e.g. first shot across the bow). There are two problems here. First, Beijing reduced export quotas for the past five years. Second, Beijing did not necessarily have a valid political objective precipitating coercive lever exercise against Japan.

As discussed in chapter III, Beijing prefers inducements to coercion in its economic statecraft. Though progressing, it lacks experience with some types of levers. Despite these conservative guidelines, coercive lever exercise can become a viable policy option in reactionary scenarios. Trade wars are an obvious trigger of retaliatory sanctions (e.g., the garlic wars). International crises offer another potential trigger. If the crisis involves nationalist sentiments, it pressurizes Beijing's crisis response apparatus. Here, senior leadership must balance competing priorities among various stakeholders and issue areas to reach a consensus decision. As the next section demonstrates, the 2010 Senkakus crisis met these criteria.

### **3. Japan says Senkaku, China says Diaoyu, Both say East China Sea**

Convergence of the 2010 Senkakus crisis with asymmetric interdependence in the REE sector provided Beijing with the opportunity to exercise the REE lever coercively. For several decades, China and Japan disputed both the territorial sovereignty of the Senkaku Islands and the maritime sovereignty of overlapping exclusive economic zones (EEZ) in the East China Sea (ECS). For Sino-Japanese relations, these disputes underscored the contentious political rivalry between East Asia's largest economic powers. Like the ongoing disputes among multiple claimants in the South China Sea, the Senkakus and ECS disputes fell into the same category of high-stakes maritime flashpoints involving China and its neighbors. This study argues that escalation of the 2010 flare-up triggered Beijing's decision to exercise the lever in the situational stage.

Informal engagement patterns governed Sino-Japanese responses to periodic flare-ups, often preventing escalation to crisis levels. Typical of the pattern, Beijing issued protests and made marginal concessions without backing down from its original claims.<sup>260</sup> Meanwhile, Japanese ships that found Chinese vessels in territorial waters, or in the Japanese EEZ, escorted these vessels outside the area without further incident. The 2010 flare-up began with a collision between a Chinese fishing vessel and a Japanese Coast Guard Vessel. When both sides departed from typical patterns of behavior, the episode escalated quickly to an international crisis involving the highest levels of leadership on both sides. Breaking with the past, Tokyo detained the Chinese captain and vowed prosecution in a Japanese court. With few viable policy options at its disposal, Beijing's departure featured explicit coercive lever exercise, a policy option it had not pursued before in a bilateral security crisis.

The nature of the Sino-Japanese disputes in the Senkakus and ECS reflected distinct historical and legal interpretations of sovereignty dating back to the 1895 Sino-Japanese War. Japan claimed the Senkakus since it incorporated the three islands and five rocks in 1895, an area no larger than three square miles.<sup>261</sup> It lost them to the U.S. in WWII until 1972, when Japan regained administrative control of the Senkakus with the return of Okinawa. Japan has administered the islands since then. China claimed the islands, which it called the Diaoyus, should have returned to China at the end of WWII. Following the discovery of hydrocarbon reserves under the seabed, both countries issued formal claims on the islands in 1970. At the same time, both sides claimed overlapping exclusive economic zones (EEZ) per the 1982 United Nations Law of the Sea (UNCLOS) over a large area in the East China Sea - 160,000 square miles of water.<sup>262</sup> In addition to vast undersea hydrocarbon resources, the waters above supported massive fish stocks vital to fishery industries on both sides.

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<sup>260</sup> Cole, *The Great Wall at Sea: China's Navy in the Twenty-First Century*, 41.

<sup>261</sup> *Ibid.*, 41.

<sup>262</sup> M. Taylor, Fravel, "Explaining Stability in the Senkaku (Diaoyu) Dispute," in *Getting the Triangle Straight: Managing China-Japan-US Relations*, ed. Gerald Curtis, Ryosei Kokubun and Wang Jisi (Washington, DC: The Brookings Institution Press, 2010): 144–164. 146.



Competing interpretations of UNCLOS informed these disputes as well. U.S. Naval War College professor Peter Dutton argued the Chinese position differed from Japan by treating EEZ claims in the East China Sea as Chinese territorial waters (e.g., “full sovereign rights and jurisdiction”), rather than as international waters open to commercial and military transit per UNCLOS. According to this interpretation, commercial ships cannot transit through China’s claimed EEZ without permission, much less fish or drill for oil. Likewise, warships could not conduct gunnery exercises or launch helicopters. Chinese claims in the South China Sea reflected the same mix of historical and legal interpretation. In contrast, Japan’s EEZ claim conformed to UNCLOS provisions based on continental shelf limits. To resolve the dispute, Japan proposed the two sides agree on a median line equidistant from the baselines of China’s eastern coast and Japan’s Ryukyu Island Chain, which China subsequently rejected.<sup>263</sup>

More frequent flare-ups in both disputed areas over the past decade coincided with increased resource competition. Given mutual status as net energy importers, the economic stakes were high for both sides. Located in the disputed EEZ area, China’s Chunxiao Natural Gas Development Project sits on top of an estimated 12.7 million tons of oil and 65.2 billion cubic meters of natural gas.<sup>264</sup> There were two promising examples of cooperation. First, Beijing and Tokyo implemented a 1997 fisheries treaty in 2000 that allowed 600 Chinese fishing vessels east of a zoning line each year. Second, in 2008, both sides reached an agreement to pursue joint exploration of hydrocarbon resources in the ECS, the first agreement of its kind between China and another country with overlapping maritime claims. Little progress occurred until negotiations began in late July 2010 to implement the agreement in Tokyo, less than two months before the 2010 flare-up. The crisis stalled further progress. Citing Japan’s decision to detain Captain Zhan and his crew, Beijing postponed the next round of negotiations originally scheduled to commence later in September.<sup>265</sup>

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<sup>263</sup> Peter Dutton, “Carving up the East China Sea,” *Naval War College Review* 60:2 (2007): 49–72.

<sup>264</sup> *Ibid.*, 50.

<sup>265</sup> Cole, *The Great Wall at Sea: China’s Navy in the Twenty-First Century*, 53; Fravel, “Explaining Stability in the Senkaku (Diaoyu) Dispute,” 160; Przystup, “Japan-China Relations: Troubled Waters.”

Bilateral episodes near the islands provoked by non-state actors were a relatively new phenomenon. Driven by resource nationalism, these incidents risked escalation to crisis levels if managed poorly by Beijing and Tokyo.<sup>266</sup> In 1996, separate groups of businessmen from Japan, Hong Kong and Taiwan stirred up international interest when they planted flags on the islands. Chinese nationalists aboard civilian vessels drew attention with their first landing in 2004. Then in 2008, China sent two maritime survey vessels to territorial waters around the Senkakus. From then on, Japan increased maritime patrols with more capable coast guard vessels. However, escort of Chinese vessels outside disputed areas remained Tokyo's policy. For its part, China repressed national media reporting on the Senkakus compared with other flashpoints like Taiwan, suggesting some reluctance in Beijing to channel nationalist sentiment to the Senkakus and ECS disputes.<sup>267</sup> For the most part, following the 2004 and 2008 flare-ups both sides took measures to prevent nationalist protestors from visiting the islands regularly.

In addition to these incidents, increased naval activity near the disputed areas heightened security tensions on both sides. In contrast with past episodes initiated by commercial actors, potential conflict between military actors posed a much greater risk. On the Chinese side, PLAN patrols in the East China Sea expanded steadily since 2004, including incursions into territorial waters around the Senkakus and Japan's claimed EEZ. Though protested consistently by Japan, and defended consistently by China, increased PLAN activity did not spiral into armed conflict. Japan monitored these events closely and shifted defense priorities to the Senkakus and ECS areas. Released a year after the 2010 Senkakus crisis, Japan's 2011 Defense White Paper noted concern with China's increased naval activity in the "waters surrounding Japan," including a recent transit by an 11-ship flotilla.<sup>268</sup> Though deliberate conflict appeared unlikely, analysts warned the frequency of both navies in the disputed areas increased the likelihood of an unintended military crisis in the long term.<sup>269</sup>

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<sup>266</sup> Dutton, 65; Swaine and Fravel, 9; Shirk, 62–64.

<sup>267</sup> Fravel, "Explaining Stability in the Senkaku (Diaoyu) Dispute," 153.

<sup>268</sup> Japan Ministry of Defense, "Defense of Japan 2011 White Paper." Accessed at: [http://www.mod.go.jp/e/publ/w\\_paper/2011.html](http://www.mod.go.jp/e/publ/w_paper/2011.html)

<sup>269</sup> Swaine and Fravel, "China's Assertive Behavior Part Two The Maritime Periphery," 9.

At least two security factors prevented China from pressing its claims with military force in past flare-ups and in the 2010 Senkakus case.<sup>270</sup> First, the Japan Maritime Self Defense Force (JMSDF) remained a formidable navy, though the maritime balance continued to shift toward the PLAN. Second, the U.S.-Japan Alliance deterred China from escalating periodic bilateral crises and risking armed conflict with the United States. In fact, this factor may explain Japanese assertiveness. For example, in each of the previous Senkakus crises – 1972, 1996, 2004, 2008 and 2010 – Japan pressed the United States to state publicly that U.S.-Japan security treaty obligations covered the Senkakus.<sup>271</sup> On September 23, senior U.S. officials made this affirmation.<sup>272</sup> A month later, during a press conference with Foreign Minister Maehara, Secretary Clinton responded to a Japanese reporter, “let me say clearly again the Senkakus fall within the scope of Article 5 of the 1960 U.S.-Japan Treaty of Mutual Cooperation and Security.”<sup>273</sup> These reassurances contributed to Tokyo’s decision to expedite resolution of the crisis on September 24, a day after indications of the REE embargo made international headlines. If this development followed the pattern since 1972, then Tokyo’s earlier decision to detain Captain Zhan marked a clear departure.

When the 2010 crisis escalated, Beijing pursued a range of coercive policy options besides military force to signal protest and resolve. From Beijing’s perspective, Tokyo’s unprecedented detention of Captain Zhan exacerbated nationalist sentiments avoided in the past by adherence to ground rules and careful diplomatic management. Beijing did not order the Chinese fishing vessel to ram Japanese Coast Guard ships, but Tokyo did allow the Ishigaki court on Okinawa to detain Captain Zhan. Following this escalation, the domestic political value of standing up to Japan outweighed immediate concern for the broader Sino-Japanese relationship.

Given the expectation of future conflict with Tokyo over the Senkakus and ECS disputes, coercion became a viable policy option. However, Beijing could not risk

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<sup>270</sup> Fravel, "Explaining Stability in the Senkaku (Diaoyu) Dispute," 153.

<sup>271</sup> *Ibid.*, 148.

<sup>272</sup> Przysup, “Japan-China Relations: Troubled Waters.”

<sup>273</sup> Hillary R. Clinton, Clinton, Hillary R., “Joint Press Availability with Japanese Foreign Minister Seiji Maehara,” Kahala Hotel and Resort: Honolulu, HI, October 27, 2010.

inadvertent military conflict with Japan or the United States by deploying warships. Instead, aggressive diplomatic and propaganda campaigns featured repeated demarches of the Japanese ambassador and public condemnations of Tokyo. Anti-Japanese protests occurred over several days in October, demonstrated Beijing's renewed willingness to allow public intervention in select foreign policy disputes for domestic political gain. In weighing additional options for escalation against Tokyo, Beijing probably calculated it could assume the risks of coercion in economic statecraft. Asymmetric interdependence with Japan in the REE sector provided the lever. In the 2010 Senkakus crisis the requisite situational elements existed for Beijing to depart from inducement preferences and exercise the lever coercively. The next section on the application stage describes how Beijing actually exercised the lever and offers a more detailed explanation for why.

#### **4. Rare Earths: An Implicitly Explicit Coercive Lever**

Short of an official document or statement linking the REE suspension with orders from Beijing, this study cannot establish empirical proof of an official embargo. There was no press conference announcing suspension; information trickled into the international media through Japanese industry sources. In response to these reports and appeals by Japanese officials to resume REE shipments throughout the two-month period, Chinese leadership repeatedly denied ordering the suspension, including Foreign Minister Yang Jiechi, MOFCOM Minister Chen Deming and Premier Wen. During a speech at the Sixth China-EU Business Summit in October, Wen did not mince his words, "we haven't imposed, and will not impose, an embargo on the industry."<sup>274</sup> Ironically, Premier Wen is a trained geologist who presumably studied REEs at Beijing Institute of Geology in the 1960s and certainly grasped China's domestic REE industry as a Vice Minister of Geology and Mineral Resources in the 1980s.<sup>275</sup> Here, implausible deniability allowed Chinese leadership to avoid public comments that might conflict with

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<sup>274</sup> *Xinhua*, "Premier Wen's Speech at Sixth China-EU Business Summit," October 7, 2010. Accessed at: [http://news.xinhuanet.com/english2010/china/2010-10/07/c\\_13545683.htm](http://news.xinhuanet.com/english2010/china/2010-10/07/c_13545683.htm)

<sup>275</sup> Official Biography of Premier Wen Jiabao. Accessed at: [http://english.gov.cn/2008-03/16/content\\_783363.htm](http://english.gov.cn/2008-03/16/content_783363.htm); Keith Bradsher, "Chasing Rare Earths, Foreign Companies Expand in China," *The New York Times*, Aug 25, 2011, B1.

China's WTO obligations. Promotion of Beijing's international reputation as a responsible major power remained a clear strategic priority.

Trade data tell a different story. Based on trade statistics analyzed by the Congressional Research Service, Chinese REE exports to Japan dropped precipitously from several thousand tons to several hundred tons during the two-month embargo.<sup>276</sup> This trend reversed course after the embargo ended. *Reuters* reported REE imports from China climbed from 634 tons in November to 4,080 tons in December based on Japanese Ministry of Finance data. Similar to the garlic wars, this spike in volume also suggests Beijing released large quantities of REEs impounded by customs during the two-month embargo. Total REE imports to Japan in 2010 were 28,564 tons, of which Chinese REE imports accounted for 82% at 23,310 tons.<sup>277</sup> Given these official discrepancies, unofficial embargo is a more precise characterization of what happened. This result begs two questions, was the REE suspension an example of an explicit coercive lever and why did Beijing adopt this approach?

Addressing the first question, this study argues the REE embargo probably began as an implicit coercive lever conveyed through diplomatic and industry channels in closed-door settings. Beijing warned Seoul in advance it would impose a retaliatory ban during the 2000 garlic war with South Korea.<sup>278</sup> Since Beijing denied imposing the REE embargo in any form, this study speculates that when the threat of REE suspension failed to persuade Tokyo to release Captain Zhan, between September 14–23, Beijing took further action. It follows that once the implicit threat of REE suspension materialized as an observable foreign policy outcome, coercive lever exercise became explicit. If the implicit threat were successful, then Tokyo would have released Captain Zhan before reports of the REE suspension. It is possible Beijing planned to exercise the lever

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<sup>276</sup> U.S. Library of Congress, Congressional Research Service, *China's Rare Earth Industry and Export Regime: Economic and Trade Implications for the United States*, by Wayne M. Morrison and Rachel Tang, CRS Report R42510 (Washington, DC: Office of Congressional Information and Publishing, April 30, 2012). See Figure 10: Chinese Monthly Rare Earth Exports to Japan in 2010, 32.

<sup>277</sup> Chikako Mogi, "Japan's Rare Earth Imports from China up 6-Fold in Dec," *Reuters*, January 31, 2011.

<sup>278</sup> Jae Ho Chung, "From a Special Relationship to a Normal Partnership?: Interpreting the 'Garlic Battle' in Sino-South Korean Relations," *Pacific Affairs* 76:4 (2003/2004): 549–568. 563.

regardless of Tokyo's subsequent behavior once the flare-up escalated to crisis levels. However, this study argues an implicit period preceded the shift to explicit exercise due to Beijing's general reluctance to exercise coercive levers in economic statecraft.

To answer why Beijing adopted this unofficial approach, it is necessary to clarify how coercive lever exercise supported desired policy objectives in the context of economic statecraft. Like Baldwin, this study assumes economic statecraft reflects embedded decision-making processes in which policy options are matched to desired objectives. Beijing does not select among levers because China is a revisionist or status quo power, Chinese leaders make consensus-driven decisions based on domestic and international constraints. Given the constraints derived from Chinese grand strategy, foreign policy making and political economy trends described in chapter III, Beijing's political objectives were short-term out of necessity. Coercion conflicted with the strategic concepts of "economic diplomacy" and "peaceful development." It was antithetical to inducement preferences. Though not a lost cause, managing the China threat in Japan placed Beijing at cross-purposes with the domestic political value of anti-Japanese nationalism. Yet the escalatory nature of the 2010 Senkakus crisis pressurized Beijing's foreign policy apparatus and altered the transaction costs of various coercive policy options.

Though willing to assume additional risk in Sino-Japanese relations, Beijing could not afford prolonged risk to its international reputation as a responsible major power. Here, unofficial coercive exercise presumably allowed Chinese leadership to avoid making public comments that would run afoul of China's WTO accession protocol. This point explains the Chinese leadership's consistent denial of the embargo and simultaneous defense of industrial policies in the Chinese REE sector (e.g., export quotas) as supporting "sustainable development."<sup>279</sup> Meanwhile, from a political economy perspective, prolonged exercise of the REE lever could quickly become counterproductive, threatening economic development priorities by disrupting supply

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<sup>279</sup> *Xinhua*, "Premier Wen's speech at Sixth China-EU Business Summit," October 7, 2010.

chains and raising concerns among other foreign MNCs based in China. Adding to uncertainty, Beijing had not exercised the REE lever before; it was an untested capability.

It follows that Beijing exercised the REE lever coercively to achieve three short-term political objectives against two targets. The primary target was the Japanese government and the secondary target was the Japanese REE industry, consisting of roughly 30 companies based in Japan. Based primarily on inductive logic, this study asserts the REE embargo advanced three short-term objectives: 1) signaling resolve by amplifying official protest against Japan without provoking the U.S.-Japan Alliance; 2) lobbying Tokyo to release Captain Zhan, ending the crisis; 3) hastening a third wave of Japanese REE business relocation to China in support of REE sector reforms.

Evidence draws from several observable outcomes. Beijing exercised the lever in ways that isolated Japan from other REE importers. The embargo only applied to concentrated REE exports consumed primarily by downstream manufacturers in Japan. As *The New York Times* Hong Kong bureau chief Keith Bradsher, who covered the crisis extensively noted, “China’s quotas and the shipping embargo have involved only shipments in which the material has a rare earth content of about 50% or more.”<sup>280</sup> Even after the embargo, Japan remained China’s primary customer for this REE type. Exports of REE-derived products (e.g., SmCo magnets) continued without incident. In fact, these products were not subject to export quotas before the REE embargo, indicating a dual incentive to promote domestic movement up the value-added supply chain and lure foreign businesses to China. In October, unconfirmed industry reports suggested that Beijing extended the embargo to the United States and Europe.<sup>281</sup> If anything, perceptions of an expanded REE embargo validated Beijing’s conservative approach to short-term exercise.

Some Chinese officials argued the suspension happened spontaneously due to widespread nationalist sentiments that manifested at the local level. MOFCOM Minister

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<sup>280</sup> Keith Bradsher, “China Is Said to Resume Shipping Rare Earth Minerals,” *The New York Times*, Oct 29, 2010, B1.

<sup>281</sup> Keith Bradsher, “China Said to Widen Its Embargo of Minerals,” *The New York Times*, October 20, 2010, B1.

Chen Deming implied as much when he said, “I believe entrepreneurs, they will have their own feelings, and will do their own thing.”<sup>282</sup> Other than as an explanation for smuggling during the embargo, this defense is problematic for several reasons. First, the REE suspension required national coordination among at least four central bureaucracies (e.g., MEP, MLR, MOFCOM, MIIT), provincial and local governments, Chinese SOEs in the REE sector, and 31 authorized REE exporters, of which nine were foreign MNCs. This level of coordination could not happen by itself. Though unsubstantiated, Bradsher references “a secret meeting in Beijing” in September 2010, in which officials notified the presidents of Chinese REE companies the embargo would occur and advised noncompliance would cost their REE production licenses.<sup>283</sup>

Second, implementation of the REE embargo occurred at the local level in a uniform way across provinces. Customs officials stalled administrative procedures, including “export license applications, customs clearance, and shipment processing.”<sup>284</sup> Reports in early September initially trickled in from Shanghai, but soon expanded to multiple provinces. Small quantities of REE exports did get through added to the confusion among Japanese industry and government officials. In late September, Japan’s METI settled the matter by surveying all 30 Japanese REE companies. The survey results indicated widespread increases in Chinese REE customs inspections. Seaborne inspection rates increased 20-30%, while air cargo rates increased 50%.<sup>285</sup> If this were not an embargo, it represented government failure across the Chinese customs apparatus.

As this study argued in Chapter III, central-local interests do not align perfectly in the Chinese REE sector. Policies attenuate from Beijing bureaucracies to local officials concerned with promoting growth and repressing social unrest. Not all Chinese REE companies benefit from REE industrial policies and tensions exist between local governments and enterprises. Prior to the embargo, rising prices favored exporters over

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<sup>282</sup> Hiroko Tabuchi, “Block on Minerals Called Threat to Japan’s Economy,” *The New York Times*, September 29, 2010, B1.

<sup>283</sup> Keith Bradsher, “Specialists in Rare Earths Say a Trade Case Against China May Be Too Late,” *The New York Times*, March 14, 2012, B2.

<sup>284</sup> Nakano, “Rare Earth Trade Challenges and Sino-Japanese Relations: A Rise of Resource Nationalism?,” 61.

<sup>285</sup> *Ibid.*, 61.



producers, who bore the regulatory costs of mining, separating and refining REEs. *Caijing* recently quoted a Chinese REE industry source in Jiangxi province frustrated with local licensing, production quotas and bureaucratic gridlock. "Even if we were granted a production quota of 600 tons of rare earths," the source noted, "where should I mine the 600 tons of rare earths (if not allowed to buy mines freely)?"<sup>286</sup>

Despite the implementation challenges of REE sector reforms, it is implausible Beijing could not execute the REE embargo given its control over the 31 licensed exporters. Equally dubious is the notion it would take two months to stop the embargo upon confirmation of suspended exports from Japan. Like the strategic and reputation management considerations, these sectorial trends constrained exercise of the REE lever by limiting duration. Prolonged suspension could disrupt domestic supply chains undermining vertical integration. Of greater potential concern to Beijing was the risk of expanded black market operations in the southern provinces, in which the vast majority of China's highly valuable heavy REE reserves were located.

Finally, in the months following the 2010 Senkakus crisis, REE shipments resumed in conjunction with thawing diplomatic relations. High-level leadership meetings on the margins of the October EAS and November APEC summits marked a downshift from coercive politics to diplomatic management. Initiated by the Japanese side, these developments reinforced Beijing's primary objective: signaling resolve and official protest. When shipments resumed in late November, there was no official announcement. The process simply reversed: customs officials reduced inspections and approved paper work; dockworkers loaded REE containers onto ships that got underway for Japan. Instead of a Chinese official, METI's Akihiro Ohata, confirmed on November 24 that Chinese REE exports had resumed to Japan.<sup>287</sup> The next section considers the effects stage of coercive lever exercise. It covers the extent Beijing achieved desired objectives, along with state and commercial responses to the REE embargo.

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<sup>286</sup> *Caijing*, "Rare Earths' Mandatory Production Plan: All of Chaos," April 9, 2012. Accessed at: <http://english.caijing.com.cn/2012-04-09/111806073.html>

<sup>287</sup> Hiroko Tabuchi, "The Hunt for Rare Earths," *The New York Times*, November 25, 2010, B1.

## 5. Do Coercive Lever Effects and Territorial Disputes Mix?

Beijing exercised the REE lever in the security context of the Senkakus and ECS disputes. As with past episodes, the 2010 flare-up represented an intense political conflict that risked military escalation. Ruling out a military response, Beijing sought policy alternatives, including the REE embargo to achieve objectives. Compared with coercive lever examples over the past decade, this case involved both economic and security objectives. Again the three short-term objectives were: 1) signaling resolve by amplifying official protest without provoking the U.S.-Japan Alliance, 2) lobbying Tokyo to release Captain Zhan, 3) hastening a third wave of Japanese REE business relocation to China. Coercive lever exercise clearly contributed to the first objective, and arguably contributed to the second objective. Since the embargo was part of a comprehensive response, “contribute” is an accurate measure. Like Baldwin, this study argues economic statecraft does not need to account for 100% of an outcome to have a meaningful effect.

In the long term, coercive lever exercise did not advance resolution of the Senkakus or ECS disputes, nor did Tokyo move any closer to Beijing politically. In fact, it moved closer to the U.S.-Japan alliance. Undoubtedly, the episode raised Japanese perceptions of the China threat. The Japanese press criticized Beijing’s behavior during the crisis and Japan’s 2011 Defense White Paper pointed to the ECS as an elevated area of concern. Whether Beijing advanced these security issues matters less than the fact that it wielded economic statecraft during a security crisis, breaking with past examples like the garlic wars and tatami mat wars in which import bans were reciprocal responses to economic disputes. The next chapter develops this point further.

It is possible Beijing overreached in pursuit of the third objective to hasten a third wave of REE business relocation to Japan. In the short term, Japanese commercial and government responses to the REE embargo were mixed. During the two-month suspension, Japanese companies survived by accessing REE stockpiles and purchasing REEs from Vietnamese traders, allegedly sourced by smugglers in Southern China.<sup>288</sup> Japanese companies already had a presence in Vietnam. For example, Showa Denko

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<sup>288</sup> Keith Bradsher, “In China, Illegal Rare Earth Mines Face Crackdown,” *The New York Times*, December 30, 2010, B1.

opened an REE alloy facility in Ha Nam province near Hanoi in 2008. Tokyo funded a 2009 REE mine development project in Vietnam that built “roads, bridges, electricity, water supply, schools, and hospitals.”<sup>289</sup> Japan’s oldest REE firm, Dowa Holdings, experimented with recycling REEs from electronics, though this effort proved analogous to turning lead into gold.

Nearly a year passed before limited indicators emerged of a third wave of REE migration to China. In August 2011, two Japanese companies, Showa Denko and Santoku of Japan, added facilities in China to guarantee access to REEs.<sup>290</sup> In response to these movements, *The Daily Yomiuri* and the *Nikkei Weekly* released editorials critical of the moves, and urged the government to intervene before additional manufacturing firms moved to China. In fact, METI announced several industrial policies in 2011, including a U.S. \$370 million subsidy for companies to research and develop REE-free technologies.<sup>291</sup>

Meanwhile, long-term changes began in the global REE industry, including supply chain diversification and the potential discovery of new maritime reserves, reversing the trend of the past 25 years. Japan’s top REE trading company, Sojitz, made a 250 million deal with the Australian firm Lynas to purchase 3,000 tons initially and up to 9,000 tons a year starting in 2013 from a new Mount Weld mine in Australia. Lynas also recently received permission from Malaysian authorities to open a facility in Kuantan that refines REEs mined from Mount Weld. Progress depends on Lynas’ compliance with environmental regulations in response to ongoing public concern with radiation hazards.<sup>292</sup> In the summer of 2011, a Japanese research team claimed

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<sup>289</sup> Japan Ministry of Economy Trade and Industry (METI), “Results of the 2nd Japan-Vietnam Coal and Mineral Resources Policy Dialogue - Toward a stronger Japan-Vietnam relationship in the field of coal and mineral resources,” Accessed at: [http://www.meti.go.jp/english/press/data/20090116\\_01.html](http://www.meti.go.jp/english/press/data/20090116_01.html)

<sup>290</sup> Nakano, “Rare Earth Trade Challenges and Sino-Japanese Relations: A Rise of Resource Nationalism?” 62.; Keith Bradsher, “Chasing Rare Earths, Foreign Companies Expand in China,” *The New York Times*, Aug 25, 2011, B1.

<sup>291</sup> Hiroko Tabuchi, “Mining Trash for Rare Earths,” *The New York Times*, October 5, 2010, B1.; *Daily Yomiuri*, “Govt to pay firms to curb rare earth use,” September 21, 2011.; *The Asahi Shimbun*, “METI to support projects to cut rare earth China dependence,” June 4, 2011.

<sup>292</sup> Keith Bradsher, “Rare Earth Metal Refinery Nears Approval,” *The New York Times*, February 1, 2012, B1.

discovery of more than 1,000 times the proven land-based REE reserves in a massive area in the Pacific Ocean spanning from Hawaii to Tahiti.<sup>293</sup>

Companies based in the United States, Canada and Germany also initiated projects to open mines outside of China. U.S. firm Molycorp reopened the California Mountain Pass mine early in 2012.<sup>294</sup> The company also announced plans to acquire one of two global REE chemical producers, Canadian firm Neo Material, a controversial development because Neo Material owns facilities in China.<sup>295</sup> Another Canadian firm, Great Western Minerals Group, launched the Steenkampskraal mine refurbishment project in South Africa to extract heavy REEs.<sup>296</sup> Representing EU interests, German Chancellor Angela Merkel personally negotiated a deal with her counterpart in Kazakhstan to allow German companies to survey and mine REEs there.<sup>297</sup>

Whether these developments become profitable depends on how quickly companies advance along the average ten-year timeline from discovery to mining operations. It took China 60 years to dominate the REE industry and it will likely remain a key supplier for several years. Similar to China's effect on energy markets, diversification of the global REE industry seems to be a long-term effect of Chinese policies on global prices and supplies, not least of all, the two-month REE embargo. It is unclear whether Beijing anticipated this shift, but given rising REE demand in China it may prove a win-win outcome.

## **6. Dilemmas Of World Trade Accession For Coercive Leverage**

This section summarizes two WTO actions associated with this case study that are potentially important in the broader context of Chinese economic statecraft. Many of the

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<sup>293</sup> Hiroko Tabuchi, "The Hunt for Rare Earths," *The New York Times*, November 25, 2010.; Anthony Rowley, *The Business Times of Singapore*, July 5, 2011; R. Colin Johnson, "Rare Earths Get Rarer," *Electronic Engineering Times*, August 15, 2011.

<sup>294</sup> See the Molycorp website at: <http://www.molycorp.com/AboutUs/AboutMolycorp.aspx>

<sup>295</sup> Keith Bradsher, "Molycorp, a Rare Earth Mining Firm, Is to Merge With a Processor, Neo Material," *The New York Times*, March 9, 2012, B8.

<sup>296</sup> Jon Herskovitz, "Analysis: Rare Earth Hunt Leads to Frontier Africa," *Reuters*, March 4, 2011. Accessed at: <http://www.reuters.com/article/2011/03/04/us-africa-rareearths-idUSTRE72319620110304>

<sup>297</sup> Melissa Eddy, "Germany and Kazakhstan Sign Rare Earths Agreement," *The New York Times* February 9, 2012, B3.

conditions of asymmetric interdependence described in this study developed since China's WTO accession in 2001 in which China deepened integration with the global economy. Accession took China nearly 15 years to achieve. It represents the culmination of Chinese commitment to market-oriented reforms and is by no means a trivial matter in Chinese political economy. However, the essence of statecraft involves weighing various policy options and matching capabilities to achievable objectives under domestic and international constraints. As this case demonstrates, this process can result in selection of policy options (e.g., coercive lever exercise) that are at cross-purposes with broader priorities (e.g., reputation management). Clearly, WTO obligations shaped Beijing's decision to exercise the lever unofficially. The relevant question is whether these shifts have a lasting effect on Chinese economic statecraft preferences. Though beyond the scope of this study, a potential area for future research relates to how ongoing adaptation to WTO rules and norms shapes Chinese economic statecraft.

The WTO dealt an indirect blow to the Chinese REE industry in July 2011, in which its dispute settlement panel issued a long-awaited ruling from a 2009 case filed by the United States, EU and Mexico. It found Chinese export restrictions on nine raw materials essential to high technology manufacturing in violation of WTO rules. Though REEs were not part of this case, the violations mirrored Chinese export restrictions in the REE industry. U.S. Trade Representative, Ron Kirk, and the EU Trade Representative, Karel De Gucht, linked the ruling to China's REE industry and called on China to change its behavior. Gucht noted, "China should ensure free and fair access to rare earth supplies."<sup>298</sup> In response to China's appeal six months later, the WTO's highest tribunal, the Appellate Body, ruled that while the settlement panel overreached in its definition of free trade violations, Chinese export policies were not temporarily applied, and therefore, were "inconsistent with China's Accession Protocol and the GATT 1994."<sup>299</sup>

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<sup>298</sup> Stephen Castle, "W.T.O. Says Chinese Restrictions on Raw Materials Break Rules," *The International Herald Tribune*, July 6, 2011.

<sup>299</sup> Keith Bradsher, "In Victory for the West, W.T.O. Orders China to Stop Export Taxes on Minerals," *The New York Times*, January 31, 2012, B1; World Trade Organization, Dispute Settlement: Dispute DS395, "China-Measures Related to the Exportation of Various Raw Materials." Accessed at: [http://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds395\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds395_e.htm) - bkmk395abr

More than 18 months after the 2010 Senkakus crisis began, the United States, Japan and the European Union filed a WTO complaint against Chinese REE export restrictions on March 13, 2012. In his remarks, President Barack Obama stated American manufacturers could not access Chinese REEs due to Beijing's policies, which "go against the very rules that China agreed to follow."<sup>300</sup> The United States played a key security role in the 2010 Senkakus crisis and U.S. companies participated in subsequent REE diversification efforts. Here, the U.S. government officially joined multinational responses to the Chinese REE industry. Beijing's response did not depart from past REE sector talking points. MIIT Minister Miao Wei acknowledged the case and noted China would defend itself.<sup>301</sup> MOFCOM issued a statement subsequently reiterated by Chinese leadership: "China's policy objective is to protect resources and environment in order to achieve sustainable development, and it has no intention of protecting domestic industries through trade-distorting measures."<sup>302</sup> Though it will take several months, if not years, before WTO adjudicates this case, it offers a key source of data for analysts interested in the effects of coercive levers in Chinese economic statecraft.

## C. CONCLUSION

In the 2010 Senkakus dispute, Beijing exercised the REE lever coercively against Japan to achieve three short-term objectives: 1) signaling resolve by amplifying official protest against Japan without provoking the U.S.-Japan Alliance; 2) lobbying Tokyo to release Captain Zhan, ending the crisis; 3) hastening a third wave of Japanese REE business relocation to China in support of REE sector reforms. Objective selection largely confirmed H2.

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<sup>300</sup> "Remarks by the President on Fair Trade," The White House. March 13, 2012. Accessed at: <http://www.whitehouse.gov/the-press-office/2012/03/13/remarks-president-fair-trade/>

<sup>301</sup> *Xinhua*, "China Prepares to Defend Rare Earth Case," March 13, 2012. Accessed at: [http://news.xinhuanet.com/english/china/2012-03/13/c\\_131464982.htm](http://news.xinhuanet.com/english/china/2012-03/13/c_131464982.htm); *Xinhua*, "China Exclusive: Experts Say No More Cheap Rare Earths From China," March 13, 2012. Accessed at: [http://news.xinhuanet.com/english/china/2012-03/13/c\\_131464546.htm](http://news.xinhuanet.com/english/china/2012-03/13/c_131464546.htm)

<sup>302</sup> Comments by Head of MOFCOM Department of Treaty and Law on US, EU and Japan Requests of Consultations on China Rare Earth Export Control at WTO March 15, 2012. Accessed at: <http://english.mofcom.gov.cn/aarticle/newsrelease/policyreleasing/201203/20120308016675.htm>

Asymmetric interdependence with Japan in the REE sector provided Beijing with the lever. Its creation in the asymmetric stage was not a deliberate strategic outcome dating back to 1949 when the REE industry became intertwined with China's political economy. Instead, the lever developed gradually as a consequence of reform era economic policies that promoted China's domestic REE sector along with other economic development priorities. Beijing recognized the lever's coercive potential over the past decade, as Japanese dependency on Chinese REE imports deepened with the accelerated movement of Japanese businesses to China. Given Beijing's preference for inducements in economic statecraft, these conditions were insufficient to support coercive lever exercise.

A combination of situational factors triggered explicit coercive exercise of the REE lever during the 2010 Senkakus crisis, including strained Sino-Japanese relations, the escalatory nature of the crisis and reactionary nationalism on both sides. In combination, these factors pressurized Beijing's foreign policy apparatus in the situational stage and its three-pronged response to Tokyo was coercive across the board. If Beijing had not met these criteria, it could not justify the costs of coercive options.

Conscious of its WTO obligations, Beijing exercised the lever unofficially, but in an observably explicit way in the application stage. Tactics targeted China's 31 authorized REE exporters and employed local customs officials to suspend REE shipments destined for Japan. Confirming H1, Beijing could not maintain the embargo indefinitely without damaging China's commercial reputation and domestic development priorities. Relations with the target state still mattered. Japan remained a major economic partner and once Tokyo initiated a diplomatic thaw, Beijing followed suit. The embargo ended quietly though it amplified international efforts to diversify REE supplies that continue to unfold in the effects stage.

Three factors made this case remarkable. First, Beijing exercised the lever coercively in ways that maximized existing conditions of asymmetric interdependence in the REE sector. Second, the lever matched the desired political objectives in terms of scope, duration and achievability. Third, Beijing exercised an economic lever in response to a security dispute against a near peer competitor that was also a formidable

economic and military power. In contrast with the Sino-American mini-case, described in the next chapter, Beijing successfully transitioned, or possibly skipped, the shift from implicit to explicit coercive lever exercise. Taken together, these outcomes suggest the role of coercive levers in Chinese economic statecraft will continue to evolve in unanticipated ways as China's economic integration with the global economy deepens.



## **V. COERCIVE LEVER APPLICATION MINICASES**

### **A. INTRODUCTION**

This chapter analyzes three mini-cases in which Beijing exercised coercive levers against South Korea (1999–2000), Japan (2001) and the United States (2010). In the Sino-Korean garlic wars, Beijing wagered the relatively higher value of Korean industrial products against its agricultural products during a trade war on the eve of WTO accession. In the Sino-Japanese garlic war, Beijing’s measured approach to explicit coercive lever exercise allowed both sides to save face and pursue the China dream. A decade later, Tokyo’s ambivalence and Beijing’s defiance produced strikingly different outcomes. Implicit coercive lever exercise backfired during the Sino-American Taiwan arms sale dispute. In fact, this last case presents obvious contrasts with the Senkakus crisis nine months later. Following the three mini-cases, this chapter offers conclusions and implications for further research, ending the study.

### **B. GARLIC, TATAMI MATS, AND ARMS: IS THIS EVOLUTION?**

#### **1. Sino-Korean Garlic Wars (Implicit and Explicit Coercive Levers)**

Asymmetric interdependence worked in interesting ways on the eve of China’s WTO accession with the first “full-scale public trade war” in Sino-Korean relations.<sup>303</sup> During the garlic wars in 2000, Beijing imposed import bans on two South Korean products, mobile handsets and polyethylene, in retaliation for South Korean tariffs on two varieties of Chinese garlic, a 315% tariff on frozen garlic and a 436% tariff on pickled garlic.<sup>304</sup> This textbook trade war marked a temporary setback in otherwise warm Sino-Korean relations. Bilateral economic exchanges reflected deepening regional integration during the reform era in which East Asian countries expanded access to the China market. Bilateral trade increased from \$19 million in 1979 to \$41.2 billion in 2003. China became South Korea’s second largest export market (~13% total) and its primary

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<sup>303</sup> Jae Ho Chung, “From a Special Relationship to a Normal Partnership? Interpreting the “Garlic Battle” in Sino-South Korean Relations,” *Pacific Affairs* 76:4 (2003/2004): 549–568. 550.

<sup>304</sup> *Ibid.*, 563.

destination for FDI. In fact, South Korea reversed the course of trade deficits and maintained an annual trade surplus with China following normalization in 1992.

Beijing exploited two forms of asymmetric interdependence. First, Beijing selected coercive levers based on the relative price differential between industrial goods and agricultural goods. Second, Beijing relied on South Korea's desire for continued access to the Chinese market for its industrial exports as a source of coercion (e.g., Studwell's "China dream"). The South Korean industrial goods represented 1.6% of the total trade volume with China and were 57 times the value of Chinese garlic imports. Asymmetric interdependence was strongest in the polyethylene sector, in which China accounted for 47% of all South Korean polyethylene exports.<sup>305</sup>

South Korean actions combined with a series of suicides related to the tariffs in China triggered coercive lever exercise in the situational stage. In contrast with Japan, Sino-Korean politics were warm and security cooperation was considerable. Beijing was an early admirer of the South Korean economy, as one of East Asia's four tigers,<sup>306</sup> and lauded its quick recovery from the 1997 Asian financial crisis. Yet rising Sino-Korean interdependence did not eliminate protectionism in South Korean domestic politics. Due to a combination of increased competition with Chinese garlic imports and rising domestic productivity, earnings dropped in the South Korean garlic sector over 1998–1999. Farmers were an important constituency in South Korean politics, and represented by the National Agricultural Cooperative Federation (NACF), pointed to China as the primary cause for falling prices. In fact, domestic production increased 22.8% while Chinese imports increased only 3.5%.

Given the prospect of an upcoming election, South Korea's Ministry of Finance and Economy (MOFE) imposed a provisional safeguard (e.g., temporary tariff) on Chinese garlic imports for 200 days in November 1999.<sup>307</sup> As South Korean garlic importers cancelled contracts, garlic producers in China's Shandong province, the source

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<sup>305</sup> Chung, "From a Special Relationship to a Normal Partnership? Interpreting the "Garlic Battle" in Sino-South Korean Relations," 552, 564.

<sup>306</sup> South Korea, Taiwan, Hong Kong and Singapore. Four Little Dragons is another variant.

<sup>307</sup> Chung, "From a Special Relationship to a Normal Partnership? Interpreting the "Garlic Battle" in Sino-South Korean Relations," 554–556.

for 80% of garlic exports, incurred huge losses. When six garlic farmers from Changshan County committed suicide, it made national headlines. This publicity added a sense of urgency to Beijing's response. Meanwhile, Seoul miscalculated Beijing's knowledge of WTO rules and its willingness to retaliate.<sup>308</sup> Revocation of the safeguards was Beijing's immediate policy objective. Though in the midst of final WTO negotiations, Beijing became determined to send a clear signal to Seoul and the international community it would not allow a state with a more developed market economy to trample on Chinese exports based on otherwise preferential relations.<sup>309</sup>

Initially implicit, coercive lever exercise became explicit in the application stage. Twice in March 2000, Beijing warned it would retaliate with an import ban on industrial products if Seoul did not remove the provisional safeguards on its agricultural products. Beijing argued that Seoul overreached by imposing unilateral safeguards when it ran huge trade surpluses with China, and questioned Seoul's compliance with WTO rules. According to GATT Article 2, provisional safeguards are not authorized unless the sending state can prove that increased imports harmed a domestic industry.<sup>310</sup> When the threat of implicit coercion failed to prevent Seoul's imposition of a full-fledged safeguard, Beijing skipped the preliminary step of tariffs and imposed an import ban on South Korean industrial products in June 2000. While the retaliatory ban also violated WTO rules, China was not yet a member. Implementation was uncomplicated: Beijing's customs apparatus enforced the ban. Over the next month, Chinese customs officials detained 27,200 tons of polyethylene and 20,000 tons of mobile handsets.<sup>311</sup>

In the effects stage, Seoul's response to the import ban reflected a shift in the domestic balance of influence from the agricultural lobby to the industrial lobby, underscoring the importance of domestic politics in the target state. Faced with \$100 million in losses, the Korean Chamber of Commerce, Korean Association for Petrochemical Industries, and the Korean Association for the Promotion of Electronics

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<sup>308</sup> Chung, "From a Special Relationship to a Normal Partnership? Interpreting the "Garlic Battle" in Sino-South Korean Relations," 567.

<sup>309</sup> *Ibid.*, 563

<sup>310</sup> *Ibid.*, 557-558.

<sup>311</sup> *Ibid.*, 565.

Industry all lobbied Seoul to drop the tariff, forcing the South Korean garlic industry to give up market share to China.<sup>312</sup> The episode ended when Seoul expanded low-tariff quotas on Chinese garlic, nulling the effect of its full-fledged safeguards over the next three years, and Beijing released the impounded products. In sum, Seoul was unprepared for a trade dispute with Beijing. The garlic wars demonstrated Beijing's willingness to "implement punitive actions" in response to increased protectionism in the target state and domestic social unrest that threatened China's economic development priorities.<sup>313</sup> Consistent with H1 and H2, Beijing did not initiate coercive lever exercise; it was a retaliatory measure designed to end the dispute quickly and signal resolve.

## **2. Sino-Japanese Tatami Mat Wars (Explicit Coercive Lever)**

The asymmetric stage of the tatami mat wars featured interesting contrasts with the garlic wars. Due to a spike in Chinese agricultural imports that lowered domestic profits, Tokyo imposed provisional safeguards in April 2001, including a 256% tariff on leeks, a 260% tariff on shiitake mushrooms and a 100% tariff on straw rushes imported from China.<sup>314</sup> Like Seoul the previous year, Tokyo faced an upcoming election and farmers were an important political constituency. In June, Beijing retaliated with 100% tariffs on Japanese automobiles, cell phones and air conditioners to persuade Tokyo to allow the preliminary tariffs to expire.<sup>315</sup> Broad bilateral economic patterns were similar to the Sino-Korean mini-case. Following normalization in 1972, Sino-Japanese economic exchanges deepened: China became Japan's primary trading partner and a major destination for Japanese businesses eager to access the China market. Occurring a decade before the 2010 Senkakus crisis, in this case Japan remained the economic center of gravity in East Asia and Tokyo projected considerable influence through its vast economic statecraft resources. For the past 20 years, China was the primary target of

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<sup>312</sup> Ross, "Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia," 374–5; Chung, "From a Special Relationship to a Normal Partnership? Interpreting the "Garlic Battle" in Sino-South Korean Relations," 564.

<sup>313</sup> Chung, "From a Special Relationship to a Normal Partnership? Interpreting the "Garlic Battle" in Sino-South Korean Relations," 550.

<sup>314</sup> Ibid., 551.

<sup>315</sup> Przysup, "Japan-China Relations: From Precipice to promise."

Japanese Overseas Development Assistance (ODA) and more than half Japan's annual ODA went there in 2000 (~\$10–15 million).<sup>316</sup>

Heading into the tatami mat wars, Japan had more aggregate economic power and asymmetric leverage than China. In 2001, Hirschmanescue logic favored Japan. In contrast, a sliver of asymmetric interdependence helped the Chinese side. Again the value of Japanese industrial products vastly exceeded the value of Chinese agricultural products. However, the Chinese share of all three industrial products in total Japanese trade was only 0.2% and the Chinese share of Japanese automobile exports was only one percent in 2000.<sup>317</sup> In sum, Japanese trade in these goods was considerably diversified beyond China; Hirschmanesque logic did not apply. Similar to the South Korean case, Beijing relied on the lure of the Chinese market as its primary defense. It turns out, Tokyo's actions in the situational stage proved more significant than Beijing's asymmetric interdependence in the relative trade value between agricultural and industrial goods.

The relative value of Sino-Japanese relations on both sides was the key variable differentiating the garlic wars from the tatami mat wars in the situational stage. Unlike Sino-Korean relations, Sino-Japanese relations featured the previously noted “cold politics, hot economics.”<sup>318</sup> Periodic flare-ups across historical and security issues plagued relations.<sup>319</sup> The most recent strain stemmed from Prime Minister Koizumi Junichiro's August 2000 visit to the Yasukuni Shrine, a memorial to Japan's war dead including 14 Class-A criminals from WWII. However, at this point in the relationship, deepening economic exchanges was an urgent priority on both sides. Beijing raced proudly toward WTO accession as Japanese companies raced confidently toward the Chinese mainland. Determined to repair relations at the October APEC summit in

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<sup>316</sup> Ibid., 566.

<sup>317</sup> Chung, “From a Special Relationship to a Normal Partnership? Interpreting the “Garlic Battle” in Sino-South Korean Relations,” 552.

<sup>318</sup> See for example, Shirk, Chapter Six: “Japan,” in *China: Fragile Superpower*, 140–180; Buruma, *The Wages of Guilt: Memories of War in Germany and Japan*; Berger, “The Politics of Memory in Japanese Foreign Relations.”

<sup>319</sup> Ross, “Balance of Power Politics and the Rise of China: Accommodation and Balancing in East Asia,” 393.

Shanghai, Koizumi visited the anti-Japanese War Memorial and issued his first verbal apology to President Jiang for Japanese victims of WWII.<sup>320</sup> This overture improved the broader climate before leading into the trade dispute, and unlike the other cases, had a calming effect on Beijing's foreign policy-making apparatus.

Both sides exercised restraint during the application stage. Compared with Seoul, Tokyo did not implement full-fledged safeguards and prolonged negotiations past the deadline to December 21. At the APEC summit in Shanghai, METI's Hiranuma Takeo consulted with MOFCOM's Shi Guangsheng but failed to resolve the dispute.<sup>321</sup> Tokyo also worried about provoking international perceptions of Japanese protectionism in the trade dispute (e.g., Japan bashing).<sup>322</sup> Certainly, these considerations paralleled Beijing's concerns with international reputation management.

For its part, Beijing's retaliation was measured compared with the garlic wars. Having just achieved accession in November, Beijing's WTO obligations weighed heavily in its approach to Tokyo. Beijing waited two months before matching tactics with Tokyo with the imposition of high tariffs. Though Beijing skipped this preliminary step with Seoul, an implicit warning occurred six days before the explicit shift to an import ban.<sup>323</sup> It is also possible Beijing warned Tokyo in advance of the tariffs. By pitting Japanese industrial products against Chinese agricultural products, Beijing again overmatched coercive levers to signal resolve and influence domestic politics in the target state. It would not remove the tariffs before Tokyo ruled out permanent safeguards. Once again, Beijing sought achievable short-term political objectives, confirming H2.

Outcomes converged during the effects stage in both the garlic wars and tatami mat wars. Like Seoul, Tokyo originally imposed the preliminary tariffs due to falling prices in its agricultural sector and due to the role of farmers as a key political constituency. Yet deleterious effects occurred in both sectors. Through October, prices

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<sup>320</sup> Przystup, "Japan-China Relations: From Precipice to promise."

<sup>321</sup> Ibid.

<sup>322</sup> Chung, "From a Special Relationship to a Normal Partnership? Interpreting the "Garlic Battle" in Sino-South Korean Relations," 552, 566.

<sup>323</sup> Ibid., 567.

continued to fall among all three agricultural products, while Japanese automobile companies reported expected losses of 420 billion yen (~\$40–50 million) if the import ban continued.

As the trade dispute continued, Japanese business migration accelerated to China in anticipation of WTO accession. Isuzu announced it would move sport utility vehicle manufacturing and sales to China by 2003, indicting the first time a Japanese automobile company broke into the Chinese market for reverse exporting.<sup>324</sup> Meanwhile, Japanese headlines pointed to a rising China economic threat and the “hollowing out” of the domestic manufacturing sector. Faced with a precarious mix of domestic political pressure and the alluring China dream, Tokyo ruled out permanent safeguards on the December 21 deadline. Interestingly, both sides agreed to establish bilateral mediation boards with government and industry representatives to resolve future trade disputes. Beijing dropped all three tariffs, ending the tatami mat wars.<sup>325</sup>

### **3. Sino-American Arms Sanctions (Implicit Coercive Lever)**

Given two high-stakes international disputes with Japan and the United States, 2010 proved a banner year for coercive lever exercise in Chinese economic statecraft. The Sino-American dispute began exactly nine months before Captain Zhan’s fishing boat collided with two Japanese Coast Guard ships in the East China Sea following a series of announcements related to U.S.-Taiwan arms sales. Like the Senkakus case, this case involved a periodic flare-up of an ongoing bilateral security dispute. Unlike the Senkakus case, coercive lever exercise did not match asymmetric or situational factors. This mini-case confirmed H1 assumptions of implicit coercive lever exercise and partly confirmed H2. The coercive lever process broke down when both the asymmetric and situational criteria were not met. Beijing had two desired political objectives: 1) protesting continued U.S.-Taiwan arms sales; 2) protesting continued U.S.-China arms sanctions. Both were intertwined with Beijing’s strategic goal of Taiwan reunification. Both objectives conflicted with H2 largely because Beijing lacked the coercive lever

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<sup>324</sup> Przystup, “Japan-China Relations: From Precipice to promise.”

<sup>325</sup> Ibid.

capabilities in the asymmetric stage to alter either policy. Though enough nationalist pressure existed in the situational stage to trigger coercive lever exercise, Beijing also overestimated its political latitude in the U.S.-China relationship, in which Hirschmanesque logic still favored the United States.

Two U.S. announcements initiated the flare-up in this case. On January 7, the Department of Defense (DoD) awarded Lockheed Martin a \$978 million dollar contract to sell Patriot Advanced Capability (PAC-3) missiles to Taiwan, approved in 2008 by the Bush Administration. As expected, Beijing condemned the sale as a violation of the three U.S.-China Joint Communiqués.<sup>326</sup> On January 29, the Obama Administration notified Congress of its intent to sell weapons to Taiwan worth \$6.4 billion dollars. The list included 114 additional PAC-3 missiles, 60 UH-50M Black Hawk helicopters, 12 Harpoon II anti-ship missiles, two Osprey-class mine-hunting ships and upgrade kits for Taiwanese F-16 A/B fighter aircraft.<sup>327</sup>

Beijing's response began January 30 with a strongly worded demarche delivered by Vice Minister He Yafei to U.S. Ambassador Jon Huntsman. It noted the sale "seriously endangers China's national security and harms China's peaceful reunification efforts." Beijing's list of consequences included limited suspension of military exchanges and cancellation of an upcoming bilateral security dialogue. Unlike any previous response to an arms sale notice, Beijing made an unusual threat: it would impose sanctions against specific companies involved in the weapons sale to Taiwan, namely Boeing (Harpoon), Lockheed Martin (PAC-3), Raytheon (PAC-3) and United Technologies (UH-50M). MFA reiterated the sanctions in public statements, but did not specify additional details. Similar to the Senkakus case, Beijing's propaganda apparatus engaged fully, pointing to myriad violations of the Three Communiqués. As discussed in chapter III, Retired military officers affiliated with NDU and AMS weighed in with

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<sup>326</sup> For background on the U.S.-China dispute over Taiwan, see for example, Deng, *China's Struggle for Status: The Realignment of International Relations*; Shirk, "Taiwan: A Question of Regime Survival," in *China: Fragile Superpower*, 181–2011; James Mann, *About Face: A History of America's Curious Relationship with China, from Nixon to Clinton* (NY: Vintage Books, 2000); *Xinhua*, "China Renews Warning on U.S. Arms Sales to Taiwan," January 7, 2010.

<sup>327</sup> Bonnie Glaser and David Szerlip, "US-China Relations: The Honeymoon Ends," *Comparative Connections* April (2010).



bellicose commentaries, including Rear Admiral Yang Yi's call to attack the profits of American companies involved in the sale. However, Beijing did not apparently follow through on these sanctions. Unlike the garlic wars or the Senkakus crisis, implicit exercise did not become explicit, nor did it last beyond early February when official references to the sanctions stopped.<sup>328</sup>

Beijing then stumbled in the application stage by selecting a lever it could not exercise credibly. In fact, a shift to explicit exercise could easily upset the balance between strategic and economic development priorities. It follows that when implicit exercise failed to achieve results early on, Beijing lacked a viable policy option to facilitate explicit exercise. U.S. Domestic political outcomes in the effects stage reinforced Beijing's mismatch between lever selection and policy objectives. Overall the case corroborates H2 assumptions that Beijing exercises explicit coercive levers rarely to achieve short-term, limited objectives. It also suggests that while Beijing struggled with execution, its coercive lever process shows signs of increasing sophistication.

Perplexed by Beijing's aggressive response to the 2010 Taiwan arms sale announcement, analysts focused on evolving Sino-American relations since the first year of the Obama Administration.<sup>329</sup> Bonnie Glaser pointed to four possible explanations for Beijing's escalatory response that inform the situational stage. First, Beijing was out of patience after more than 60 years of U.S. arms sales to Taiwan and expected the new Obama Administration to meet the spirit of the 2009 U.S.-China Joint Statement. Second, Beijing felt compelled to react strongly given the expectation of a nationalist backlash in elite and populist circles that perceived the sales as U.S. encroachment on "China's core interests." Here, the case had two of Shirk's three nationalist triggers by involving Taiwan and the United States (but not Japan). Third, based on a honeymoon

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<sup>328</sup> Glaser and Szerlip, "US-China Relations: The Honeymoon Ends"; Alan D. Romberg, "2010: The Winter of PRC Discontent," *China Leadership Monitor* 31 (2010): 1-31; *Xinhua*, "Arms Sale Causes Severe Damage to Overall Chinese-U.S. Cooperation," January 30, 2010; *Xinhua*, "China to Halt Military Exchanges, Punish U.S. Companies for Arms Sales to Taiwan," January 30, 2010. Keith Bradsher, "U.S. Deal With Taiwan Has China Retaliating," *The New York Times*, January 31, 2010, A15; Bill Gertz, "Chinese see U.S. debt as weapon in Taiwan dispute," *The Washington Times*, February 10, 2010.

<sup>329</sup> Romberg, "2010: The Winter of PRC Discontent," 4, 16; Glaser and Szerlip, "US-China Relations: The Honeymoon Ends."

period with the Obama Administration, marked by Obama's successful visit to China in November 2009, Beijing expected Washington to delay the 2010 arms sale or at least begin reducing the quantity of weapons sold in accordance with the Three Communiqués. Fourth, Beijing believed that due to its stabilizing efforts during the 2008 financial crisis, "the power gap between China and the US was shrinking and that China's growing clout provided Beijing with greater leverage to deter US arms sales to Taiwan."<sup>330</sup>

Based on the above analysis, two situational elements aligned to trigger coercive lever exercise: Beijing's perceived gains in prestige and nationalism provoked by U.S.-Taiwan foreign policy issues. Several factors constrained Beijing's coercive lever selection in the exercise stage. Beijing lacked sufficient asymmetric interdependence in the U.S. arms sector to make its implicit sanctions credible. The desired objectives were beyond the scope of Beijing's capabilities against the target state. The United States remained the world's largest global economy and its only superpower; Beijing's inflated prestige could not make up the differential. In sum, the 2010 arms sale announcement was not a high-stakes crisis. Though Beijing consistently protested past Taiwan arms sale announcements, the 2010 announcement paled in comparison to the 2008 arms sale in which Beijing suspended military-to-military diplomacy.<sup>331</sup>

Underscoring the first problem, none of the U.S. companies named by Beijing had military contracts with China, nor had any received substantial commercial contracts over the past five years.<sup>332</sup> Due to multiple U.S. arms sanctions against China, some dating back to 1949, U.S. companies remain prohibited from "exporting defense articles and defense services" to China.<sup>333</sup> Of the four, Boeing had the largest market exposure in China with a commercial presence there since 1972. In fact, Chinese aviation parts manufacturers built "horizontal stabilizers, vertical fins, the aft tail section, doors, wing

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<sup>330</sup> Glaser and Szerlip, "US-China Relations: The Honeymoon Ends."

<sup>331</sup> Romberg, "2010: The Winter of PRC Discontent."

<sup>332</sup> Ibid., 6.

<sup>333</sup> U.S. Library of Congress, Congressional Research Service, *China Economic Sanctions*, by Dianne E. Rennack, CRS Report RL31910 (Washington, DC: Office of Congressional Information and Publishing, February 1, 2006).

panels, wire harnesses and other parts,” for several Boeing airframes.<sup>334</sup> During the dispute, Raytheon pursued a contract to provide air traffic control systems in Shenyang Airport, but had an otherwise marginal presence in China. United Technologies sold air conditioners and elevators in China, not Black Hawk helicopters. In sum, with the exception of Boeing, the U.S. companies did not depend on the China market for a significant profit margin.<sup>335</sup>

In addition to Beijing’s weak asymmetric interdependence in the arms sector, a shift to explicit coercive lever exercise conflicted with broader strategic and economic priorities. Despite the appearance of Chinese opportunism in U.S-China relations, the domestic political balance in China still favored inducements over coercion. Consistent with the reform policy of “opening,” Beijing wanted to lure companies to China based on its international reputation as a responsible major power. If Beijing looked forward to the unlikely event of future U.S. arms purchases, then threats against U.S. arms companies were counterproductive. Prospects of a “win-win” outcome that supported “peaceful development” were much greater if based on the lure of China’s booming commercial aircraft market. In 2010, Boeing estimated rising demand in Chinese domestic air travel would require a projected supply of 3,800 aircraft over the next 20 years valued at \$400 billion.<sup>336</sup> Given Boeing’s integral role in the Chinese aviation parts sector, explicit sanctions would likely disrupt local supply chains and reduce export profits. Sanctions would also potentially scare U.S. companies and the competition.

Beyond asymmetric and situational weaknesses, Beijing’s limited influence effects in the target state posed a major obstacle in this case. In contrast with the garlic wars and tatami mat wars, Beijing apparently misjudged its influence over the arms sector in U.S. domestic politics. Since none of the four companies sold arms to China, Beijing could not target the profits from U.S. arms sales there, much less arms sales to

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<sup>334</sup> Boeing Corporation, “Boeing in China.” Accessed at: <http://www.boeing.com/aboutus/international/docs/backgrounders/chinabackgrounder.pdf>

<sup>335</sup> Kelsey Swanekamp, “China’s Taiwan Stance May Damage U.S. Defense Firms,” *Forbes*, February 3, 2010; Ken Wills and Jim Wolf, “China: U.S. Arms Sales to Taiwan Hurt National Security,” *Reuters*, January 31, 2010.

<sup>336</sup> Swanekamp, “China’s Taiwan Stance May Damage U.S. Defense Firms.”

Taiwan. Here, implicit sanctions rang hollow and lacked political credibility. In fact, stock market prices of all four companies held steady despite the sanctions announcement.<sup>337</sup> Additionally, the value of annual multi-billion dollar DoD contracts vastly exceeded the value of each company's commercial contracts in China. Again, Boeing presents a possible exception due to its integral role in the Chinese aviation industry and the expectation of future aircraft sales. As argued above, actual sanctions would probably damage domestic productivity and threaten a major aviation supplier in China. Instead, Beijing's sanctions threat was unlikely to intensify lobbying in Washington to end a policy that clearly benefitted the U.S. arms sector.

Beijing's response to the 2010 arms sale announcement also raised perceptions of the China threat in Congress and protectionist debates over balance of payment issues. Beijing's timing was unfortunate as well with midterm congressional elections nearing. As discussed in chapters II and III, U.S. perceptions of the China threat evolved over the past two decades in which China gradually replaced Japan as the primary U.S. trading partner and economic competitor. China's currency policy, creditor status and massive trade surpluses became useful explanations for a declining U.S. manufacturing sector. Though lacking official weight, retired Major General Luo's suggestion China should try "dumping some U.S. government bonds," became sufficient evidence of the threat.<sup>338</sup> As the Taiwan arms sale dispute played out in Congress, President Obama made comments to senators in February suggesting the U.S. Treasury Department might declare China a currency manipulator for the first time in 16 years. Senator Grassley commented that such actions might "get China's attention and lead to a more level playing field for U.S. exporters."<sup>339</sup> Ironically, Beijing's implicit sanctions yielded more value in U.S. domestic politics than in Chinese economic statecraft.

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<sup>337</sup> Swanekamp, "China's Taiwan Stance May Damage U.S. Defense Firms."

<sup>338</sup> Bill Gertz, "Chinese See U.S. Debt As Weapon in Taiwan Dispute," *The Washington Times*, February 10, 2010.

<sup>339</sup> Doug Palmer, "UPDATE 1-Senator Urges Obama Call China Currency Manipulator," *Reuters* February 3, 2010; Carey Boles, "Senators Urge U.S. Action on Chinese Currency Manipulation," *The Wall Street Journal*, February 25, 2010.

From Beijing's perspective, it probably looked as though the 2010 Taiwan arms sale dispute risked evolution to a full-scale U.S.-China trade war. Noting the U.S. currency debate as evidence of "China bashing," a *Xinhua* editorial declared, "China has become the largest victim of U.S. trade protectionism since the outbreak of the global financial crisis."<sup>340</sup> Interestingly, MOFCOM announced February 5 it would impose dumping duties on imports of U.S. chicken parts.<sup>341</sup> Though a profitable product, this explicit lever lacked the magnitude of REEs in Japan. For China, the economic consequences of designation as a currency manipulator far exceeded the impact of threatened arms sanctions against the United States. Having tested the new administration with a battery of coercive threats, Beijing refocused diplomatic emphasis on mutual cooperation. A tuning point occurred during meetings between Deputy Secretary of State James Steinberg and State Councilor Dai Bingguo in Beijing in March. It became clear to Chinese officials the U.S. side would not back down from its Taiwan policies. Having tested the new administration with a battery of coercive threats, Beijing refocused diplomatic emphasis on mutual cooperation. By late March, both sides made efforts to mend ties and the Treasury Department did not follow through on its implicit threat to declare China a currency manipulator.<sup>342</sup>

Ironically, the RMB and debt levers presented Beijing with stronger policy options than the arms sanction lever it ultimately selected in this dispute. At least two factors prevented selection. First, as discussed in chapter III, Beijing is reluctant to exercise these levers explicitly, though this preference could change with additional experience. Second, situational conditions in the U.S.-China relationship would not trigger either lever as a viable policy option despite provoking Chinese nationalism. Beijing's prestige did not convey additional explicit leverage in the relationship, while implicit exercise raised perceptions of the China threat in U.S. domestic politics.

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<sup>340</sup> *Xinhua*, "What's Behind U.S. Pressure on Renminbi Exchange Rate?" February 20, 2010.

<sup>341</sup> Glaser and Szerlip, "US-China Relations: The Honeymoon Ends."

<sup>342</sup> Romberg, "2010: The Winter of PRC Discontent," 4, 16; Glaser and Szerlip, "US-China Relations: The Honeymoon Ends."

Similar to the REE lever, the RMB and debt levers evolved from reform era policies intended to pave the way for WTO accession and promote export-led growth. Key policies in 1994, “unified China’s foreign exchange regime, devalued the currency, and established current account convertibility.”<sup>343</sup> Until 2005, Beijing pegged the RMB to the dollar and kept its value low to promote exports. Following China’s WTO accession in 2001, surging Chinese exports created large annual trade surpluses with the United States. Because the RMB was not convertible on the capital account, Beijing balanced its trade surplus by purchasing U.S. treasury bills. By 2008, China replaced Japan as the United States’ largest foreign creditor.<sup>344</sup> By 2010, China owned about seven percent of U.S. debt (~\$1.3 trillion), reached an unprecedented trade surplus of \$273 billion and faced constant U.S. pressure to revalue the RMB.<sup>345</sup> While subject to contentious policy debates, none of these conditions emerged without complementary U.S. actions, including credit-driven consumer demand, large fiscal deficits and a declining manufacturing sector.<sup>346</sup>

Though Beijing did not transition to explicit exercise in the application stage, this mini-case does suggest signs of coercive lever evolution in Chinese economic statecraft. The garlic wars and tatami mat wars were textbook trade disputes involving retaliatory tactics like tariffs and import bans. Like the 2010 Senkakus crisis, the arms sale crisis was not a trade dispute. Instead, Beijing exercised an implicit coercive lever in the context of an ongoing security dispute with strong nationalist overtones. Though in this case, actual execution did not match achievable political objectives and Beijing could not make the shift to explicit exercise. While the garlic wars and tatami mat wars were textbook trade disputes involving tariffs and import bans, this case featured a new tactic. Beijing had not imposed micro-sanctions against U.S. arms companies in a highly

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<sup>343</sup> Naughton, *The Chinese Economy*, 104.

<sup>344</sup> Drezner, “Bad Debts: Assessing China’s Financial Influence in Great Power Politics,” 8.

<sup>345</sup> For current figures, see U.S. Census data, accessed at: <http://www.census.gov/foreign-trade/balance/c5700.html>

<sup>346</sup> Blanchard, “China’s Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China’s Sovereign Wealth Fund and Renminbi Policies”; Drezner, “Bad Debts Assessing China’s Financial Influence in Great Power Politics”; Kirshner, “The Consequences of China’s Economic Rise for Sino-U.S. Relations: Rivalry, Political Conflict, and (Not) War.”

publicized dispute before, a tactic employed by the United States.<sup>347</sup> Though poorly executed, this development suggests another level of sophistication in the role of coercive levers in Chinese economic statecraft that could yield different results in future cases.

### **C. CONCLUSION AND IMPLICATIONS FOR COERCIVE LEVERS**

Coercive levers play an increasingly nuanced role in economic statecraft. In the four cases analyzed in this study over the past decade, Beijing moved from textbook trade disputes to coercive lever exercise in response to high-stakes security crises. With the exception of the Sino-American mini-case, these studies largely confirmed both hypotheses tested in this study. The two hypotheses were: (H1), China applies explicit coercive levers rarely, and instead prefers the flexibility of implicit coercive levers; (H2), when China does apply explicit coercive levers, the intent is to achieve limited outcomes such as signaling resolve, official protest or short-term shifts in a target state's behavior. If H1 informs Chinese preferences in economic statecraft, then H2 informs desired political objectives of coercive lever exercise.

This study found that coercive lever exercise remains rare relative to inducements in Chinese economic statecraft. Exercise patterns were reactionary. If another state initiated a trade war, Beijing retaliated. Beijing also demonstrated it will exercise coercive levers during high-stakes international crises, but only to an extent exercise supported limited political objectives such as signaling resolve, amplifying protest or accelerating dispute resolution. In both types of scenarios, coercive lever exercise contributed to a coordinated foreign policy response. It follows that if Beijing adopts a broadly coercive response during future crises, the likelihood of coercive lever exercise increases. In all four cases, Beijing worked with the target states to repair relations, underscoring dispute resolution as a principal desired objective in Chinese economic statecraft. Though reluctant to exercise coercive levers, China's capabilities are evolving and it is becoming a more confident practitioner of an increasing range of policy options in economic statecraft.

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<sup>347</sup> Chris Buckley, "UPDATE 1-China Denounces U.S. Sanctions on Company Dealing with Iran," *Reuters*, January 14, 2012.

This study highlighted coercive levers derived from asymmetric interdependence in specific sectors that allowed Beijing to punch above its weight class in economic statecraft. Within China, these conditions often developed as unintended consequences of reform era policies that promoted deepening economic exchanges and integration with the global economic system. Beijing's recognition of levers derived from asymmetric interdependence increased its policy options during bilateral disputes with more powerful states or near peer competitors. In some cases, coercive lever exercise became a suitable alternative to military force. These findings contributed to previous research on the political consequences of interdependent economic exchanges by Hirschman, Keohane and Nye, Kirshner and Papayouanou among others. These findings do not alter Beijing's preference for inducements over coercion in economic statecraft. Coercive levers may proliferate but exercise will likely remain a relatively rare event.

This study divided into two parts. Part one developed essential background for the case studied by surveying strategic and political economy trends informing Chinese economic statecraft. Corroborating H1, the study found that due to grand strategic and economic development priorities, Beijing prefers inducements rather than coercion in economic statecraft. Economic statecraft fit in by assuaging perceptions of the China threat abroad and promoting China's international reputation as a responsible major power. Corroborating H2, the study found that though Chinese economic statecraft has become increasingly important in Chinese grand strategy, political economy trends can limit the duration and scope of coercive lever exercise. Due to the political primacy of economic development, coercive lever exercise can quickly reach the point of diminishing returns by threatening development priorities. This finding explains constraints on lever selection and exercise duration.

These strategic and economic guidelines did not impose hard constraints on Beijing's foreign policy behavior in the context of economic statecraft. During bilateral trade disputes, Beijing typically preferred the flexibility of implicit coercive levers, exercised behind closed-doors. If implicit exercise failed and events escalated to crisis levels that exacerbated nationalist sentiments, then the intervening role of Chinese foreign policy making could facilitate explicit coercive lever exercise as a viable policy



option. If coercive lever exercise exacerbated perceptions of the China threat or threatened domestic development priorities, then Beijing adjusted tactics. Bearing on H1, this study assumed closed-door examples were more abundant, particularly since this tactic posed less risk to China's international reputation. Largely due to inadequate evidence, this study failed to adequately differentiate between closed-door and public examples of implicit coercive lever exercise. Future research could build on Drezner's hidden hand of coercion and apply game theory modeling to additional cases in Chinese economic statecraft.

Part Two featured four case studies involving China, South Korea, Japan and the United States. The first two occurred on the eve of China's WTO accession and the last two occurred a decade later. This study approached the case studies through a staged process based on Baldwin's means-ends analysis of economic statecraft. This study assumed that coercive lever exercise did not necessarily correlate with revisionist or status quo behavior. It attempted to treat China as a neutral foreign policy actor that weighed the benefits and risks of various policy options against a range of domestic and international constraints. Like all forms of statecraft, this decision-making process represented the essence of economic statecraft. As an analytical tool, the staged process sought to isolate sequential stages of coercive lever exercise in Chinese economic statecraft to demonstrate how Beijing moved through asymmetric, situational, exercise and effects stages in each of the four case studies.

The study found the nature of asymmetric interdependence and relations with the target state were the key causal variables, consistent with research by Papayouanou, Kastner, Drezner, Kirshner, Shirk and Segal. The garlic wars confirmed H1 and H2, by demonstrating clear examples of implicit and explicit levers that matched to achievable short-term objectives. China-South Korea relations were clearly warm, and yet Beijing imposed an import ban to signal resolve against Seoul. It selected a lever that maximized the value differential between industrial and agricultural products in ways that amplified influence effects in the domestic politics of the target state. This case also featured clear evidence of both implicit and explicit exercise. Beijing warned Seoul in advance it would impose the import ban and then followed through with official action.

Nationalism sparked by the farmer suicides also played an interesting role in this case by adding a sense of urgency to Beijing's foreign policy apparatus, a factor clearly evident in the Taiwan arms sale and Senkakus crisis cases.

Beijing adopted similar tactics against Japan in the tatami mat wars, but both sides demonstrated restraint. H1 was partly confirmed in this case. Beijing did adopt a measured approach in the application stage compared to the garlic wars, and it is possible Beijing warned Tokyo in advance of its high tariff impositions during a closed-door session. The case was a clear example of H2 due to the proportional relationship between explicit coercive lever exercise and discreet political objectives. Once Tokyo dropped the temporary safeguards, Beijing dropped its high tariffs. Asymmetric interdependence was slightly weaker in this case, but comparable lever selection with the garlic wars had similar influence effects in Japanese domestic politics. Interestingly, nationalism was not a factor in this case. On both sides, optimism based on the China dream loomed large in the wake of China's WTO accession.

In the 2010 Taiwan arms sale case, Beijing selected the implicit sanctions lever based on weak asymmetric interdependence in the U.S. arms sector. It then matched the lever to unachievable political objectives beyond official protest. This case partly confirmed H1. When implicit exercise failed to achieve favorable influence effects in U.S. domestic politics, Beijing recognized the implicit sanctions lever lacked credibility. By then, it could not shift to explicit coercive lever exercise. In fact, the threat of sanctions exacerbated U.S. perceptions of the China threat and played into protectionist politics (e.g., China bashing). Though the dispute provoked high levels of nationalism, asymmetric interdependence in the arms sector did not support Beijing's inflated prestige. As the world's largest economy and its only superpower, the United States retained a considerable Hirschmanesque advantage over China that proved insurmountable in this case. Though poorly executed, Beijing's micro-sanctions against the four U.S. arms companies revealed another level of sophistication in coercive lever tactics that bears watching during future scenarios.

Rising international scrutiny over China's RMB and debt levers was part of this study's inspiration. Each symbolizes the mutual risks of deepening U.S.-China

interdependence. Beijing has not exercised either lever in the context of a major bilateral dispute, including the 2010 Taiwan arms case. There are several potential scenarios in which it could apply U.S. debt as a coercive lever, from the least likely nuclear option of dumping all U.S. securities to a more likely gradual approach based on past quarterly reductions.<sup>348</sup> As Blanchard, Kirshner and Drezner argue, Beijing remains reluctant to exercise either lever coercively and prefers the influence effects of its creditor status. As such, Beijing did not exercise the debt lever in the 2010 Sino-American case, despite its relative strength compared to the implicit arms sanctions lever. Implicit threats have increased since then. For example, Beijing criticized U.S. fiscal management in the wake of Standard and Poor's downgrade of the U.S. credit rating in the summer of 2011.<sup>349</sup> Future research could consider various situational elements in bilateral crises in which Beijing could decide to assume the risks of debt lever exercise against the United States.

As the heart of this study, the 2010 Senkakus case partly confirmed H1 and clearly confirmed H2, in which Beijing exercised the REE lever to achieve three short-term political objectives against Japan. The reactionary nature of coercive lever exercise under crisis conditions confirmed H1 predictions. However, implicit exercise predicted by H1 was not apparent due to Beijing's consistent denial of the REE embargo. Three features differentiated this case from the others. First, Beijing exercised the lever coercively in ways that maximized existing conditions of asymmetric interdependence in the REE sector. Second, the lever matched the desired political objectives in terms of scope, duration and achievability. Third, Beijing exercised an economic lever in response to a security dispute against a near peer competitor that was also a formidable economic and military power. These findings suggest the role of coercive levers in Chinese economic statecraft will continue to evolve in unanticipated ways as China's economic integration with the global economy deepens.

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<sup>348</sup> *Caijing*, "China Cut U.S. Treasury Holdings for 3rd Straight Month," February 16, 2012. Accessed at: <http://english.caijing.com.cn/2012-02-16/111684751.html>; *Caijing*, "China Yuan Still 'Undervalued' Says Geithner," January 29, 2012. Accessed at: <http://english.caijing.com.cn/2012-01-29/111642364.html>

<sup>349</sup> Bob Davis, "China Slams U.S. Over Debt," *The Wall Street Journal*, July 21, 2011; Keith B. Richburg, "China Bluntly Tells U.S. to End its 'Addiction to Debts,'" *The Washington Post*, August 6, 2011.

As this study went to press, the *Yomiuri Shimbun* published an editorial noting reports that Beijing suspended Philippine banana imports through increased quarantine inspections. These reports coincided with a tense China-Philippines flare-up in the South China Sea that began in April when the Philippine Navy inspected a Chinese fishing boat near waters claimed by both sides. Connecting these events with the 2010 Senkakus crisis, the editorial reached a coercive conclusion: “The government has justified these responses by citing an increase of anti-China protests in the Philippines and the detection of pests in bananas, but it is likely that Beijing is attempting to pressure Manila over the shoal dispute.”<sup>350</sup>

Perhaps Beijing impounded bananas rather than adopting more deadly forms of coercion. Perhaps as Kastner and Papayoanou warned, these events mark the beginning of a retreat from the pro-growth consensus in Chinese politics. If global demand for Chinese exports declines to an extent that Beijing has increasing difficulty delivering the goods to Chinese citizens, then perhaps a fundamental shift in preferences from inducements to coercion is possible in Chinese economic statecraft.<sup>351</sup> As this study stressed, such an outcome would reflect a significant reorientation of Chinese strategic and political economy trends. Even then, the decision-making process of statecraft will intervene as Beijing weighs the costs of exercising various levers to achieve desired political objectives. At the very least, analysts can expect Beijing to repeat coercive lever tactics developed during the Senkakus crisis against target states in other regions, though not necessarily repeat exercise of the REE lever. As China continues to deepen integration with the global economy, coercive levers derived from asymmetric interdependence will likely proliferate. Whether these tools become coercive policy options depends on the evolving role of Chinese economic statecraft within the international system.

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<sup>350</sup> *The Yomiuri Shimbun*, “China-Philippine Confrontation a Warning for Senkakus,” May 24, 2012.

<sup>351</sup> Keith Bradsher, “China Output Slows Sharply; Ripples Feared,” *The New York Times*, May 25, 2012, A1.

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